

Seven Broad Lessons for the United States from Japan's Lost Decade

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The simplest way to tackle the topic would be to say we should do what Heizo Takenaka did when he was the responsible minister in Japan in 2001–2005, and things will be okay. Unfortunately, we are unlikely, with the current vetting process, to get Takenaka-Sensei to become head of the National Economic Council. So I will try to drag out in a little more detail what should and should not be done. I think there are about seven major lessons to be taken.

The first point is that—as much as Prime Minister Junichiro Koizumi and Minister Takenaka were heroes—Japan did not have to lose the decade of the 1990s the way it did. And I think we have to start from that point. There are people—such as Richard Koo, Stephen Roach—well-known to all of you who talk about “balance-sheet recessions,” and the idea that you have such a huge loss of asset values on household and business balance sheets. They seem to say that the private sector and thus the economy just cannot sustainably recover until that overhang is worked through. And there was that counsel of despair influential at times in Japan and to a lesser degree there is that now here. So I just want to stress that I think what Takenaka and his colleagues did, and what the Obama administration and the Federal Reserve are now doing, in essence, is right. Policy activism to support the economy is the right response.

I firmly believe that Japan would have recovered in 1995 had there not been bad fiscal and monetary policies and neglect of the banking system. I firmly believe Japan could have still recovered in 1998, had there not been neglect of the banking system and then reversals by the Bank of Japan. And, therefore, it takes nothing away from the credit to the Koizumi team that Japan did eventually recover in 2002 when the right policy measures were undertaken. So I think that's the first point—that the bias towards activism, while it does have its costs, while we have to think about it, is the right one. That bumper-sticker from Japan, is correct.

The second lesson, which is the big ticket right now, is the question of spending money on stimulus versus spending money on the banks. And several of us have noted that the reason we have this convoluted public-private partnership, non-bank, bad-bank, pseudo-bank, aggregator-bank thing coming out of the Treasury to rescue the banks is because the Treasury feels that must do everything to avoid going to Congress asking for money for banks appropriated on-budget. I feel the Obama Administration's pain on this. But if you take a broader historical perspective, that essentially hesitation to finally fix the banks is what kept Japan from doing the right thing, in a sense, throughout the 1990s.

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The Japanese government did put money into cleaning up the *Jusen* (failed mortgage lenders tied to the banks) to some degree. The Japanese government did put money, in 1997 and 1998, to dealing with some failed institutions. Even the Yanagisawa plan of 1999 was a failure, as well, in the sense that, I fear, the Geithner plan will turn out to be—that it was too much of a giveaway to the banks with too little conditionality, even though it was well-intended. If it had been successful, you wouldn't have had to have Takenaka come in four years later and really write down the value of the assets. There were always publications of estimates of the number of non-performing loans on the banks' books. You can do a comparison of what the IMF and the private-sector people thought were the non-performing loans, versus what the government said they were. And in 1998-2000 there was a very large gap between the estimates. It was only after the measures taken in 2002 that the market assessments and the IMF assessments matched the official government assessments. Eventually, the non-performing loans officially declared by the government went up after the inspections in 2002. And very shortly after that, the IMF and market participants' assessments converged very fast down to where the Japanese government's were.

So the US is facing today a situation like that of Japan, and of other financial crises, in that recapitalizing the banks is very politically unpopular, and people said, "Well, we should be spending money on stimulus and jobs, and not on the banks." And then you get situations like we have. And I think the important lesson of this, again, is not despair, but a certain amount of humility. That we all can remember Larry Summers and others running around—and I was a junior member of this coalition—yelling at the Japanese officials in the late 1990s, and backing people like Takenaka Heizo and Ito Takatoshi and others who wanted to do the right thing, and saying, you know, "Do it, do it, do it!" Well, it's harder when it's your own country, and you find out you can't just do it. So that doesn't mean that the Geithner plan is wrong. As I've written, I think it may succeed, and if it does, it will succeed at a very high wealth transfer from taxpayers to certain financial firms. That may be the best deal that could be done right now. I would have hoped not, but I'm not in that position to make that call.

My concern is that we are not seeing Takenaka in 2002 right now, we are seeing Yanagisawa in 1998. That we are seeing someone who comes in, who has some good intent as a reformer, who is held to be a reformer, but who, in the end, for political reasons, wants to give away money to the banks with too little conditionality, and doesn't want to close any banks. And we will see if that's the case. If that is the case—again, if it is Japan in 1998 and Yanagisawa, instead of Japan in 2002 and Takenaka—more probably what will happen is 18 months, two years down the road we're just going to have to put more capital into the banks. That is standard for this type of process. And that's why, for all the talk about lack of complexity in Sweden, the real accomplishment of the Swedes was they got it done. It's not about complexity of an economy, it's about politically getting it done.

The third lesson I would take, which comes directly out of this—and this is something that was very actively demonstrated, repeatedly, in Japan, is: fiscal stimulus works, but only so far. If you engage in fiscal stimulus, you do get a multiplier greater than one. And even if you engage in wasteful fiscal stimulus—bridges in northern Hokkaido Island that get 10 cars a day or, as was reported in the Post the other day, we're going to do something about Mormon crickets here in Utah—it still has a positive multiplier. Such spending may not be a good idea long-term and, all else being equal, you might want to do things that have longer term benefits—infrastructure investment, I think, has a good case here. But even wasteful spending does buy you time, it does buy you growth in the short-run. It does prevent unemployment from rising more than it otherwise would.

The key point, though, is that little if any fiscal spending generates sustainable growth without continued expenditure. And I mean that in two senses. First, as Japan demonstrated, you cannot move 13 percent of your workforce into construction in an advanced economy. It's not a good idea. Second,

and more importantly, if you do not fix the banking system by the time your stimulus runs out, then private demand will not pick up when the stimulus runs out. That's what we saw in Japan in 1997, that's what we saw in Japan in 1999–2000. So we have a clock ticking here in the US. Again, I hope to be wrong, and see that the Treasury plan does resolve the banking problems in this country before the stimulus runs out in roughly 18 months. We will see. But if the banking problems are not in some substantial way resolved by then, we should expect another downturn in the United States at that point.

Fourth lesson—monetary policy and deflation. One of the striking things—and I'm not alone in noticing this by any means, but I still don't think it gets enough attention—is how inertial, how sticky, deflation was in Japan. Once deflation started, it went down to a negative-1 percent roughly annualized rate, depending on which index you look at. But the bottom line was it never accelerated. Even when the economy stayed bad, it didn't start going to minus-2, minus-4—which a straightforward Phillips Curve model that has continued to predict pretty well on upside moves on inflation using the output gap in Japan would have predicted.

This fact has a few implications. The first is that monetary policy did not remove deflation quickly in any easy way. Second, it meant that deflation was actually less destructive than some of us worried it might be. It certainly didn't help matters, but you didn't see a lot of enormous drag and disruption, debt-deflation cycles in the economy that you might have worried about *ex ante*. And third, we simply do not understand deflation very well. Whatever type of standard macro model, you will find it difficult to generate this result. If you use a right-leaning real business-cycle model, you don't have money and prices anyway, so you can't really model it. If you use a normal new-Keynesian model, you really can't get that result, either.

Now, as a researcher, you say, “Oh, boy, maybe I can find out about that.” But in terms of monetary policy, I think it calls for, again, a bit of humility. The Federal Reserve is right to be throwing money at our current problem. But I think we should stay away from very mechanistic monetarism that, “Oh, boy, they've printed a lot of money so at some point that has to turn into inflation.” Or, “If we do this kind of quantitative easing, it will lead to this result.” There was a paper by Bernanke, Reinhart and Sack that tried to make the case that the quantitative easing in Japan actually did work in that sense.² But I have very strong doubts about that paper, and Kuttner and I among a number of others got the opposite result, i.e., no meaningful effect from quantitative easing as practiced in Japan.³ It is open to intellectual debate, and you have to go to some pretty heavy econometric lengths to get evidence of such impact, and there is no evidence of Japanese inflation.

I think what we're seeing today from the Federal Reserve—which is indeed what we saw with the Bank of Japan in the 1990s—is monetary policy that is largely directed towards alleviating concerns in specific markets. So the way the BOJ moved into the commercial paper market, which has been emulated very successfully by the United States right now, removes the obstruction, at least temporarily, in that market. And that's helpful. I think the market-direct purchase of longer government bonds, as the Federal Reserve is moving into, as the Bank of England is already doing, as the Bank of Japan did for awhile, I think that has some direct positive effects as well—mostly through accommodating fiscal policy. But I don't think we should be viewing this as standard textbook, “We print a lot of money. It has this effect. Let's try to make a guess what the money multiplier is,” because that's just not consistent with what we've seen.

² Ben S. Bernanke, Vincent R. Reinhart, and Brian P. Sack, “Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment”, *Brookings Papers on Economic Activity*, no. 2 (Fall), 2004, pp. 1-78.

³ Kenneth N. Kuttner and Adam S. Posen, “The Great Recession: Lessons for Macroeconomic Policy from Japan,” *Brookings Papers on Economic Activity*, no. 2 (Fall), 2001, pp. 93-175.

The next three lessons are much shorter. Fifth—even if the government wants to do the right thing, keep pressuring them. This may sound self-justifying for my writing op-eds, but the lesson remains valid. I think it was useful that the US government and the IMF and the OECD and various other institutions did put pressure on the Japanese government to do the right thing during the late 1990s right into the Takenaka era when they were pushing on a more open door. There were obviously always concerns about overplaying your hand for Japanese domestic politics, and the United States looking too dictatorial. But I think the Japanese experience says that today it is perfectly right and reasonable for the rest of the G-20, from the Chinese and the U.K. on through the list, to say to the United States, “Get your house in order.” And even if Treasury Secretary Timothy Geithner whispers, *sotto voce*, off the record, “Well, I really am going to do the right thing,” we heard that from Japanese officials in the 1990s, too, and what’s good for the goose is good for the gander.

The sixth lesson concerns the fundamental and largest difference between Japan’s case then, and United States now—which we all, of course, recognize, but which should not be ignored. The global economy is in a very different place today than in the 1990s. Japan, despite the Asian financial crisis of 1997-98, for most of its period of prolonged recession was able to export to a glowing world economy, and had a substantial real depreciation of the currency without getting too much of a negative response from other governments. Shifting to domestic consumption, ignoring ‘leakage’ of demand abroad from domestic fiscal measures, and so on, is obviously much more fraught and difficult when world trade is falling off a cliff. And there is much more room for political fallout of what are correctly or incorrectly—but largely correctly—perceived as zero-sum moves in currency depreciations and beggar-thy-neighbor in a global recession. And we should be worried about that.

The final lesson has to do with the state of Japan’s economy right now being quite poor, even though for nearly seven years Japan experienced a very long-lived recovery, from late 2002 into 2008. The sharp collapse of demand in Japan in recent months has occurred even though the current Japanese FSA and the banks in Japan essentially avoided many of the mistakes that their American, British and Continental European counterparts made. So I think there’s one key lesson to be taken from this for when we talk about financial regulatory reform. There has been a lot of loose talk, and some serious talk, about how the real problem in the US banking system was, “We didn’t have lenders with enough skin in the game. Securitization was bad. People didn’t have enough at stake so they made bad decisions.” I think Japan shows that this is too simple, if not unfounded.

When you look at Japan’s banking system right now, and a major part of the problem in the Japanese economy isn’t just the trade loss, it’s that the major commercial banks still have cross-shareholdings with other industrial companies. When the economy turned down for even good companies in Japan, like Canon and Toyota and Fuji Xerox, that eroded the capital base of the Japanese banks, and that further accelerated the credit crunch—even though they had done the right thing, largely, in terms of their loan book. And the flip-side of that is we’re all becoming increasingly aware of how many of these banks in the United States—and I use the term “bank” very loosely—that the investments that were supposed to be off balance sheet actually were not off balance sheet in the end. The people at Bear Stearns had 80 percent of their retirement savings in Bear Stearns stock it appears, and they still ran the firm into the ground. So I think another lesson from Japan that is relevant today is we cannot simply say, “Arm’s length finance is bad. Relationship finance is good.” It’s a little more complicated than that.

It is worth pointing out that there is another key difference between today’s financial crisis in the US and that in Japan ten or fifteen years ago. For the most part, the Japanese assets were less complicated, and they were less toxic, and they still had a huge negative impact on the real economy. The Japanese were just “distressed,” for the most part, down significantly in value with banks not

wanting to sell them at market prices. What do I mean by “toxic” as distinct in terms of asset pricing? An asset is toxic when not only is the price going down a lot, not only do very few people want to purchase such assets, but that it is almost impossible to put a price on the assets in question. We have found in the US some of the problem is that it is difficult to disentangle the more toxic assets’ relationship to other securities, both underlying the assets and as comparables. While there were some exceptions in Japan, for example, real estate loans where *yakuza* (organized crime) had certain holds on resales, basically, Japan, like the United States in the savings and loan crisis, could go with a real RTC model and just do it.

How different are things now in the United States? I don’t want to pretend that all the distressed assets on the banks and other financial companies’ books are fitting my definition of toxic. Some of them are just distressed, and the banks don’t want to sell them as cheaply as people want to buy them. You know, that’s life, and sufficient toughness with the banks as discussed above removes that problem. But I do think there is a subset of assets in the US case—some of which having to do with derivatives, more of which having to do with real-estate securitization—that genuinely are toxic in the sense that I defined it.

And to me this is an argument for *more* government intervention rather than less. In the Japanese case, in the United States in the 1980s, you could do some relatively simple things to get the market going. For large sections of these toxic assets in the United States, however, you basically need somebody who holds a majority or a super-majority of the asset classes to start putting things back together and unwinding what’s going on. And it seems to me that the only way you’re going to get that is the government purchasing. And that, to me, is one of the other problems with the public-private partnership currently underway. Maybe the Obama Administration intends to sell to the public-private partnership whatever is good, or marketable. And the US government will be left with the lemons. But, in a sense, that’s okay *IF* then you restructure the truly toxic and sell them at a higher rate once the value is restored—and the government prices these at near-zero when taking them from the banks. But I think that that would be the key difference for US today versus Japan then, with regard to the assets. That, if anything, I think there’s a stronger argument for the US government buying, temporarily, a very large position in these assets in order to restructure them.