One of the great ironies of the current financial crisis is that US policymakers appear to have learned key lessons from Japan’s failures to deal with its financial crisis of the early 1990s.

Paul Sheard, Nomura International’s Global Chief Economist, examines the resolute action that Japanese politicians and policymakers should embrace this time around.

As the global economy struggles with the worst recession and financial crisis since the Great Depression of the 1930s, Japan has been thrust into an ambivalent limelight. On the one hand, much attention is being paid to the lessons of the Japanese financial crisis and deflation of the 1990s, and how these should be applied in the US and elsewhere. On the other hand, Japan itself is being hit badly by the global downturn, sending Japanese policymakers scurrying to deal with a deepening domestic recession and worsening deflation. Even if US policymakers have learned the lessons of the Japanese financial crisis — and it seems they have — have Japanese policymakers? It would appear not.

Although Japan’s economy is far from the US housing and credit bubbles that began the crisis, the impact of the global recession on Japan has been severe. The economy contracted at a seasonally adjusted, annualized rate of 12.1 percent quarter-on-quarter in the fourth quarter of 2008, far worse than the 6.2 percent contraction in the US economy. Industrial production has fallen by 31 percent since its peak for this cycle (February 2008), again far worse than the 11 percent drop from peak for US industrial production (January 2008).

Nor have financial markets escaped: the TOPIX stock index has fallen to a new post-1980s low, down 61 percent from its February 2007 high, and off 76 percent from its all-time high. The US S&P 500, on the other hand, is down 57 percent from its September 2007 peak, which was also its all-time high.
All of these numbers attest to the fact that the Japanese economy never fully recovered from the financial crisis and deflation that followed the bursting of the 1980s asset price bubble. Although the policy goal of overcoming deflation was trumpeted for years in Japan, it was never convincingly achieved. In the fourth quarter of 2008, the GDP deflator, a measure of the overall price level in the economy, rose in year-on-year terms for the first time since the first quarter of 1995, adjusted for the FY1997 consumption tax hike. Over the past five years, the deflator has averaged -1.0 percent year-on-year. The level of nominal GDP in the fourth quarter of 2008 was 4 percent below its 1990s peak. By contrast, over the same period, the level of GDP in the US increased by a cumulative 72 percent and in the euro-zone by 56 percent. Japan’s consumer price index and domestic corporate goods price index did re-enter meaningful inflation territory, peaking at 2.3 percent in July 2007 and 7.4 percent in August 2008, respectively, but this reflected the commodity price boom, particularly in oil, an event largely exogenous to the Japanese economy.

The version of the core CPI that excludes food and energy managed to “peak” at 0.2 percent year-on-year in the second half of 2008, but the latest reading in January 2009 showed it falling at the same rate. The Bank of Japan has yet to raise the policy interest rate above half a percent, as it has effectively been pegged at zero from early 1999 to mid-2006, except for a brief period in 2000-01. This despite the bank signaling its intent to gradually raise rates back to a normal level.

The economic “recovery” that began in 2002 was driven by exports and capital investment linked to exports. It was fuelled by the US consumption boom and China’s post WTO-entry capital investment boom, not Japanese domestic demand. The stock market recovery that saw the TOPIX rise 135 percent from its April 2003 low to its February 2007 high was driven by foreign investors: foreigners bought a record ¥33 trillion of Japanese equities in that period, which meant that Japanese domestic investors were, perversely, net sellers in their own equity market during what was supposed to be the post-bubble recovery and reflation. When Chinese and US import demand collapsed, the Japanese economy went into a deep recession. And when the financial crisis triggered foreign net selling of Japanese equities, the equity market nose-dived.

In the current global crisis, policymakers outside Japan are focused on the need to avoid Japan’s mistakes during the so-called “lost decade,” but the Japanese economy is still suffering from the legacy of those policy errors.

So what are the lessons of the Japanese crisis? There are three, all of which were standard economic policy prescriptions even before the Japan experience reinforced their wisdom. First, crippled banking or financial systems need to be fixed quickly, and this requires strong government intervention; it is not wise to try to grow out of a banking crisis. Second, in a deflation or liquidity trap, fiscal policy needs to be the central policy and large-scale and sustained fiscal expansion is required. Third, the policy response of the government and the central bank needs to be forceful, determined and coordinated.

Japan broke all three of these rules. First, the cornerstone of banking system policy was forbearance, the opposite of a pro-active fix-it-quick strategy. The equity and land price bubble started collapsing in 1990-91 and financial institutions started to fail in 1992, but it was not until 1995 that the government responded with a nationwide bank bailout plan. In June 1995 the government...
announced that it would fully guarantee all bank deposits, thus heading off a potential collapse of the banking system. Then, in 1996, the government put in place a five-year financial stabilization plan, which was scheduled to run until the end of March 2001, at which point the guarantee on normally uninsured large-lot deposits would lapse.

The premise of the government’s bailout plan was that, given five years to repair their damaged balance sheets and helped by a seven-fold increase in deposit insurance premiums, the banks would grow their way out of trouble without an injection of government funds. By September 1995, the Bank of Japan had cut the policy interest rate to a historically low 0.5 percent and there had been a number of fiscal stimulus packages.

There were two problems with this approach. First, the scale of the underlying “stock” problem — the implicit hole in bank balance sheets — was too large to be solved by a multi-year allocation of “flows.” Second, monetary policy operates through the banking system, which requires banks that are willing to lend and, less visible but more important, firms and households that are willing to borrow. The attempt to fix a crippled banking system and a bad-debt-encumbered corporate sector by using monetary policy when the banking system and de-leveraging corporate sector stymied the effectiveness of monetary policy, was doomed to failure.

Given the scale of the problem, there was no way for Japan to fix its banking system and remove the bad debt burden on bank, corporate and household balance sheets other than for the government to inject a massive amount of public money — on the order of 10 to 20 percent of GDP. However, the political and policy consensus in Japan, made rock solid in the wake of the 1995 jusen (housing finance company) debacle, was that the injection of public funds was not politically feasible because it was too unpopular with voters.

In the current global crisis, policymakers outside Japan are focused on the need to avoid Japan’s mistakes of the so-called ‘lost decade,’ but the Japanese economy is still suffering from the legacy of those policy errors.
As a public policy argument, this was a non-sequitur: the only way to solve the problem was to mobilize public funds. Saying that this could not be done did not cause the problem to go away. In the event, the escalation of the financial crisis in late 1997 paved the way for the government to use public funds for bank recapitalization (first in 1998 and then, on a larger scale, in 1999) and the purchase of non-performing loans, but it was a case of too little, too late. The guarantee on large-lot bank demand deposits was not lifted until March 2005, marking the end of a decade-long official bank workout.

Japan's second policy error was to eschew the use of expansionary fiscal policy. Even worse, it made fiscal consolidation a prime policy goal despite the economy being in serious deflation. Fiscal policy acquired a bad name in Japan in the mid-1990s after a number of spending packages failed to turn the economy around and government debt continued to mount. The policy consensus inside Japan, but challenged by non-Japanese economists, was that expansionary fiscal policy had been tried, did not work and therefore should not be used. In fact, by the time the Junichiro Koizumi administration was formed in April 2001, a policy camp arguing against the Keynesian logic that fiscal consolidation could help overcome deflation had gained primacy. But none of these arguments made sense. Given the scale of the balance sheet problems and the macro de-leveraging that was under way, and the fact that Japan had entered a deflation and a liquidity trap by the mid-1990s, the fiscal stimulus packages that were implemented were too small to turn the economy around. Stop-start fiscal stimulus packages should not have been expected to work. To be effective, fiscal expansion needed to be large, sustained and combined with similarly forceful monetary and banking system polices. This kind of fiscal policy was never tried. And fiscal consolidation in the midst of deflation was simply counterproductive. Two wrongs don't make a right.

From a macroeconomic standpoint, the argument that Japan did not have the fiscal firepower or that its government debt problem needed to be tackled before deflation was vanquished, was ill conceived. Japan has run a current account surplus for decades and the size of the surplus increased from the mid-1990s. This meant that Japan was generating surplus savings and was providing these to the rest of the world. By the most basic of macroeconomic identities, private sector savings (net of investment) plus the government deficit equals the current account balance. The large government deficits were more than offset by the savings surplus in the private sector. In other words, the government deficits that so exercised the fiscal authorities and pundits were fully domestically financed. Japan had, and still has, plenty of “room” to expand the government deficit as part of a package of policies to generate sufficient aggregate demand to overcome deflation. This was certainly the consistent message that the bond and currency markets were sending.

The third lesson from Japan is that in a financial crisis, particularly when there is a risk of or actual deflation, monetary, fiscal and financial system policy all need to be mobilized in a consistent, coordinated and forceful way to achieve the policy goal. Half-hearted policy responses, or policy responses operating at cross purposes, minimize the chance of success. In Japan’s case, as touched upon above, banking system and fiscal policy operated at cross purposes to monetary policy; and, although the Bank of Japan over time adopted increasingly non-conventional policies, such as a zero interest rate policy, quantitative easing and risk asset purchases, these were generally late or limited in scale and often communi-
Have policymakers elsewhere learned from Japan’s experience? US policymakers are certainly behaving as if they have.

The irony is that Japan, faced with its own deep recession, worsening deflation and distressed equity market, appears to be using the same old playbook.