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Two Lost Decades? Why Japan's Economy Is Still Stumbling and How the U.S. Can Stay Upright

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A weak Japanese economy is again making Americans nervous. For the fourth quarter of 2008, Japan reported a painful 12.7 percent annualized drop in GDP—a low point in a disappointing economic performance that stretches back to the early 1990s.[1]

The extent of Japanese stagnation has been understated—much more than a decade has been and is still being lost. The relevance of this stagnation to America's current economic crisis therefore goes beyond how the Japanese handled their financial crisis almost 20 years ago to a continued failure to revitalize the Japanese economy in sustainable fashion. This traces back to Japan's failure to move its economy away from structural reliance on exports and trade surpluses. The U.S. has the mirror problem: a reliance on imports, including imported savings.

A heated and important debate is underway as to how America should respond to its financial crisis and the deepening recession. Another lesson from Japan is that, if the U.S wants to secure long-term prosperity and the future of American leadership, it must also be concerned about the next two decades. If the U.S does not fundamentally change its tax, spending, and regulatory policies, this nation risks replaying Japan's two lost decades, with all that entails.

The Loss of the 1990s. On December 29, 1989, Japan was completing the fourth decade of its economic ascent. The Tokyo stock market set yet another record,[2] and Japan was the world's second largest economy. Real GDP growth had easily surpassed that in the U.S. the previous four years, the previous decade, and the previous four decades.[3] The country was not only wealthy; it was dynamic: Many named Japan the crown prince of global economic leadership, replacing an America that could no longer compete.

A decade later, this all seemed a strange dream. Japan's retreat from the economic pinnacle has been illustrated in many ways.[4] The loss was less one of wealth—Japan is still rich—than of the dynamism displayed for nearly two generations and the utter destruction of any aspiration to global economic leadership.

The stock bubble popped in 1990, followed by real estate in 1991.[5] The impact of these bubbles on GDP growth was seen clearly in 1992. By itself, this was unremarkable. As has been made all too clear, financial bubbles are common. What sets Japan apart is that its relative weakness was most stark a full seven years after the Nikkei began its swan dive.

Data on the gap between actual output and potential output in Japan and in the U.S. indicate the difference in their comparative performance was insignificant from 1991 to 1994.[6] It is in 1995, five

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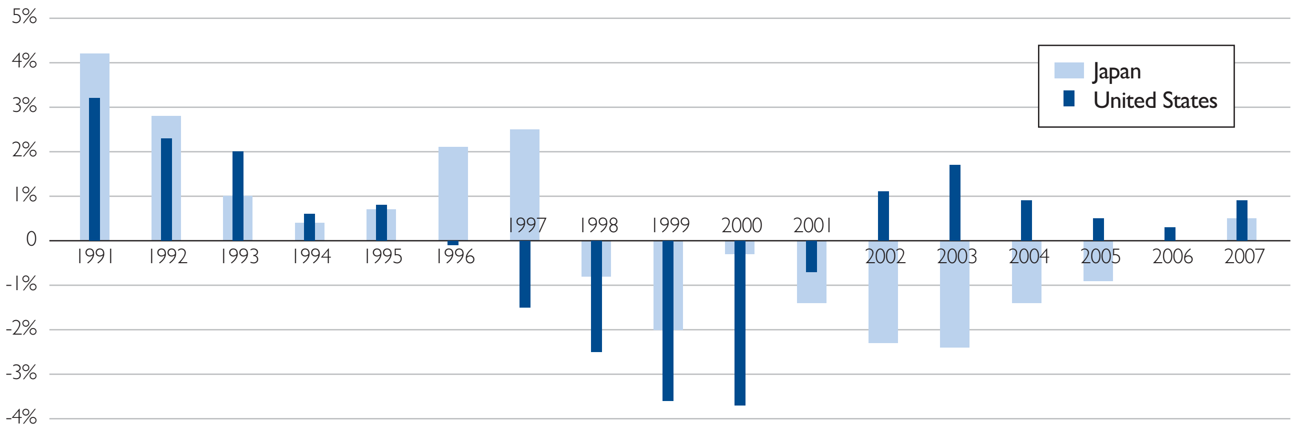
Gap Between Potential and Actual Output

Japan lags the United States most sharply a full six years after suffering the financial crash.



Sources: Congressional Budget Office, *Table F-11: Deficits, Surpluses, Debt, and Related Series, 1969 to 2008*, January 13, 2009, at *http://www.cbo.gov/ftpdocs/99xx/doc9957/Historicaltables09-web.XLS* (February 23, 2009); Quarterly output gap revisions database, Organisation for Economic Co-operation and Development, Statistics Directorate, August 2008 at *http://www.oecd.org/document/11/0,3343,en_2649_33715_41054465_1_1_1_1,00.html* (February 23, 2009).

Chart 1 • WM 2307 heritage.org

years after the initial shock, that comparative Japanese performance sharply deteriorates.

The low point in terms of that performance is 1997, but the gap between actual and potential output indicates a much weaker performance in Japan than in the U.S. as late as 2000. The lost decade is not a tale of excessively slow recovery from financial shock; it is a story of initial weakness followed by extended slump due to a failing economic model.

This shapes the lessons that should be drawn from Japan's economic woes. There is consensus that Japan failed in maintaining financial transparency in the early part of the decade. There is no equivalent consensus on the ineffectiveness of the profligate use of fiscal stimulus: As the slump actually worsened as time passed, it is difficult to see the benefit of the stimulus.[7] The standard response is to cite 1997, when Japan moved off net stimulus, as undermining the effort. It is at best a weak argument that seven

1. Tomoko A. Hosaka, "Japanese Economy Withered in Late 2008," *The Washington Post*, Monday, February 16, 2009, at *http://www.washingtonpost.com/wp-dyn/content/article/2009/02/15/AR2009021501961.html* (February 22, 2009).
2. Yahoo Finance, "Historical Prices for the Nikkei 225," February 20, 2009 at *http://finance.yahoo.com/q/hp?s=%5EN225* (February 22, 2009).
3. United States Department of Agriculture, Economic Research Service, "Real Historical Gross Domestic Product (GDP) and Growth Rates of GDP," December 16, 2008, at *http://www.ers.usda.gov/Data/Macroeconomics/Data/HistoricalRealGDPValues.xls* (February 22, 2009).
4. Ronald D. Utt, "Lessons on How NOT to Stimulate the Economy" Heritage Foundation *Backgrounder* No. 1495, October 22, 2001, at *http://www.heritage.org/Research/Budget/BG1495.cfm.*
5. Sebastian Moffett, "Japan's Bubble Burst May Not Echo in U.S.," *The Wall Street Journal*, July 12, 2005, at *http://www.realestatejournal.com/buysell/markettrends/20050712-moffett.html* (February 22, 2009).
6. Examining the output gap is a way of controlling factors beyond the influence of short-term policy. For instance, Japanese GDP growth may decline simply due to less labor input, which is relevant to Japan but not to the policy lessons to be drawn.
7. These are the lead points in Kim Holmes, "Learn Economic Lessons from Japan," *The Washington Times,* November 6, 2008, *at http://www.washingtontimes.com/news/2008/nov/06/learn-economic-lessons-from-japan* (February 22, 2009).

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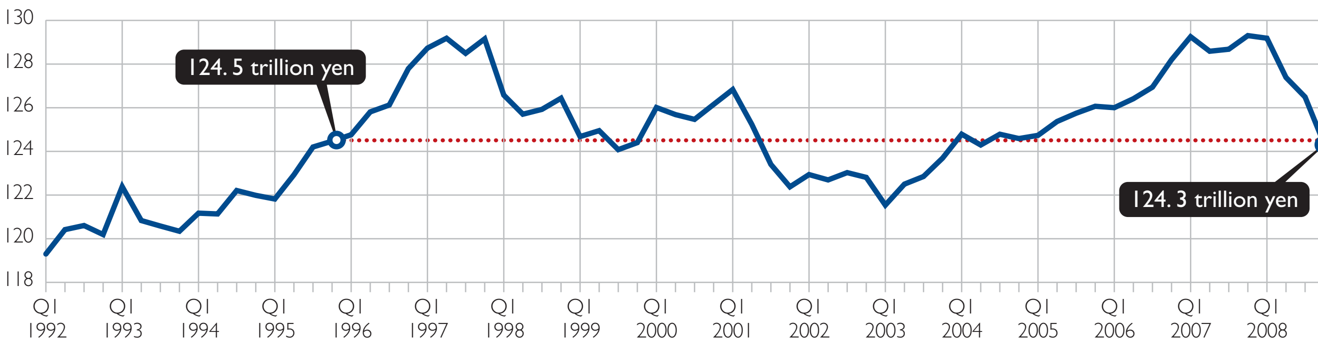
Japan's Fluctuating Economy

At the end of 2008, Japan's Gross Domestic Product was slightly lower than its level at the end of 1995.

GDP, in Trillions of Yen



Source: Organisation for Economic Co-operation and Development, StatExtract, Dataset 1: Gross Domestic Product, at *http://stats.oecd.org/wbos/Index.aspx?datasetcode=SNA_TABLE1* (February 22, 2009).

Chart 2 • WM 2307 heritage.org

years of colossal debt-financed spending was a clear failure but eight would have done the trick.

You Call This a Rebound? In any case, while determining the implications of the 1990s is valuable, it may encompass only half the story: The 2000s are rapidly becoming a second lost decade.

They did not start out that way, however. Again using the gap between potential and actual output to compare the two economies, Japan finally began to close the American advantage by 2002 and through 2005 in a long-expected and much-needed bounce from the period of underperformance. But in 2006–2007, the belated Japanese cyclical rebound faded and the two countries fared roughly equally. Unfortunately, output gap data for Japan are not yet available for 2008.

What is available, though, is shocking, perhaps even more so than the headline 12.7 percent GDP drop. A very simple comparison of quarterly results in current yen shows that the Japanese economy was likely smaller in the fourth quarter of 2008 than it was in the fourth quarter of 1995.[8]

Even worse, there is no sign the first quarter of 2009 will be stronger. If annualized growth "recovers" to only a 10 percent decline in the first quarter, the Japanese economy could be smaller than it was in the first quarter of 1992. If the outright contraction continues through 2009, the futility will continue. Seventeen years have been lost, not a decade: Prolonged stagnation combined with the collapse of an unsustainable rally is pushing Japan backward in time.

Drawing Different Conclusions. That situation is "unsustainable," not "unsustained." When Japan was sliding backward in the late 1990s, there was vigorous debate over the need for structural reform—to forcibly reduce both the ultimate dependence on exports and the distortion of monetary policy in service of currency stability in order to boost domestic private consumption.[9] The debate was muffled by the relative success of 2002–2005.

That success has turned out to be a chimera. The reversal of the output gap in 2002 coincides exactly with a sharp jump in Japan's trade surplus. The

8. Organisation for Economic Co-operation and Development, StatExtract, Dataset 1: Gross Domestic Product, at *http://stats.oecd.org/wbos/Index.aspx?datasetcode=SNA_TABLE1* (February 22, 2009).
9. A major proponent of structural reform is Richard Katz, for example, in Japanese Phoenix, ME Sharpe, 2003.

higher surplus persisted for several more years before flattening out, timed with the leveling of comparative Japanese output performance.[10]

Now as export markets are drying up in the face of the global recession, the trade surplus is plunging, and Japan is again sharply underperforming (on the basis of simple GDP, at least).[11] Structural weakness in the form of export obsession has come home to roost. Looking forward, there is good reason to believe it will be more difficult for balance-of-payments surplus countries to fully recover from the current crisis than for deficit countries.[12] The angry disagreements over whether structural reform could have saved some of the 1990s must be extended to include whether such reform could have improved the transient, wasted recovery this decade.

Possible lessons for the U.S. should likewise be extended. Rather than only examining 1990s Japan to see what should (not) be done in response to today's financial crisis, America must look well down the road. Japan has suffered over a decade of effective economic stagnation, a loss so great that it is in many ways no longer a regional economic leader, let alone a challenger for global economic leadership.

The U.S. has much more to lose: the loss of its long-standing global preeminence. Whatever the details, 17 years of net American economic stagnation would effectively end the post-Second World War era, with potentially frightening consequences around the globe. There is a heavy obligation to avoid such a development, perhaps equal in weight to the obligation to lift the American economy in the near term.

Avoiding American Lost Decades. In many respects, the U.S. economy has mirrored Japan's. While Japan built its economy around an unsustainable export-based model, America has run large, unsustainable, and (until very recently) ever-growing trade deficits. Since the beginning of the decade, the U.S. has accumulated a trade deficit of more than $4.5 trillion.

An important difference between Japan and the U.S. is that the Japanese export-led model is explicitly a matter of government policy. Japan set out to construct such an economy decades ago and, as a matter of government policy, has been unable to move toward a more balanced model. In contrast, there is no American policy favoring large trade deficits. On the contrary, a more balanced trade position is preferred.

Although persistent and unsustainable American trade deficits are not a desired policy outcome, they do follow naturally as a consequence of a wide range of federal policies. In the area of tax policy, for example, the U.S. maintains the second highest corporate tax rate among industrialized countries, limiting the international competitiveness of American businesses.[13]

In addition, the federal income tax often punishes many forms of saving by taxing the returns to saving at high marginal rates.[14] Discouraging domestic saving means importing significant amounts of net saving from abroad, the flip side of importing significant amounts of net good and services from abroad.

Among the many other federal policies contributing to the trade deficit:

10. Japan's Ministry of Internal Affairs and Communications, Statistics Bureau, the Director-General for Policy Planning (Statistical Standards) and the Statistical Research and Training Institute, "Chapter 18 Foreign Trade, Balance of Payments and International Cooperation," 2008, at *http://www.stat.go.jp/english/data/chouki/18.htm* (February 22, 2009).

11. Japanese External Trade Organization, "Japanese Trade and Investment Statistics," 2008, at *http://www.jetro.go.jp/en/reports/statistics* (February 22, 2009).

12. Michael Pettis, "Asia Faces a Tough 2009 as Output Decreases," *Financial Times*, December 14, 2008, at *http://www.ft.com/cms/s/0/9f5cfb76-ca0b-11dd-93e5-000077b07658.html* (February 22, 2009).

13. Ambassador Terry Miller and Anthony B. Kim, "High Corporate Taxes Undermine U.S. Global Competitiveness," Heritage Foundation *WebMemo* No. 2065, September 15, 2008, at *http://www.heritage.org/Research/TradeandEconomicFreedom/wm2065.cfm*.

14. Stuart M. Butler, "Making Savings the Default Option," Heritage Foundation *Commentary*, September 4, 2008, at *http://www.heritage.org/Press/Commentary/ed090408d.cfm*.

- The federal tax treatment of health insurance distorts the insurance market, encouraging excessive coverage and driving up health care costs.[15]
- U.S. energy policy is replete with contradictions, the net effect of which is to diminish domestic energy production and increase energy imports.[16]
- Federal spending is absorbing a large and increasing share of resources, some spent in innovative fashion, some spent on the social safety net, but much spent foolishly and wastefully.[17] An excellent example is how the federal government subsidizes the health insurance of high-income seniors through the unquestionably unsustainable Medicare program.
- A wide range of regulatory policies distort allocation of resources across a spectrum of activities. The federal government maintains thousands of regulations relating to worker safety, consumer protection, environmental protection, market competition, and more, some of which may have been justified at one point but today are antiquated, ineffective, overreaching, and burdensome on America's companies.

Whether Japanese trade surpluses or American trade deficits, large, persistent international trade imbalances are truly unsustainable.

The U.S. at Risk. Japan's lost decades stem partly from an inability to reconfigure their economy away from export reliance. The U.S. risks its own prolonged period of weakness if it fails to correct the policies that have contributed to excessive trade deficits and reliance on foreign saving. And in the case of American stagnation, the consequences would be far worse.

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15. Nina Owcharneko, "Health Care Tax Credits: Designing an Alternative to Employer-based Coverage," Heritage Foundation Backgrounder No. 1895, November 8, 2005, at *http://www.heritage.org/Research/HealthCare/bg1895.cfm*.
16. Ben Lieberman, "No Energy in the House Energy Bill," Heritage Foundation *WebMemo* No. 1542, July 9, 2007, at *http://www.heritage.org/Research/EnergyandEnvironment/wm1542.cfm*; Jack Spencer, "Nuclear Power Needed to Minimize Lieberman–Warner's Economic Impact," Heritage Foundation *WebMemo* No. 1944, June 2, 2008, at *http://www.heritage.org/Research/EnergyandEnvironment/wm1944.cfm*.
17. Brian M. Riedl, "Federal Spending by the Numbers: 2008," Heritage Foundation *WebMemo* No. 1829, February 27, 2007, at *http://www.heritage.org/Research/Taxes/wm1829.cfm.*