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Japan's Economic Failure and America's Economic Risk

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Japan's economic performance is ghastly. The first quarter of 2009 was arguably the nation's worst on record, building on a terrible end to 2008. Naturally, debate rages over how the Japanese government should respond. Questions also persist over how the government should have responded to the weakness of the 1990s. These two debates are linked.

In hindsight, Japanese economic policy in the 1990s was an utter failure. A major part of that was the government's refusal to restructure the economy, which would have speeded recovery from the "lost decade" and cushioned the present crisis. Instead, throughout the 1990s, Tokyo spent and spent. Yet it was exports that appeared to finally end the lost decade, not government spending. Now the export valve is shut off and, having eschewed restructuring, Japan has again turned to public spending and debt and again faces stagnation.

The Japanese example is critical to an America caught in a financial crisis. The U.S. must look beyond present economic weakness and resist phony cures such as fiscal stimulus, which carry enormous long-term costs with no long-term benefits. The U.S. must do what Japan should have done—cease government actions that impede economic reform—or risk stalling any advance in American living standards for a generation.

Reevaluating Japanese Economic Performance. Japan's economic timeline has been grim for almost two decades. The bubble economy of the late 1980s was originally deemed a sign of success, similar to the U.S. technology bubble 10 years later. The ensuing pop was doubly loud because Japanese stocks and property were badly overvalued at the same time, while in America the stock market bubble preceded the housing bubble by some years.

That Japan suffered a financial shock is not news, but there are still important aspects of the crash that are not well understood. How long it took for the economy to hit bottom, for instance, remains an open question. The view as recently as mid-2008 was that it took a full six years to reach the bottom of the crash: from the property market collapse in 1991 to the low point for comparative GDP growth in 1997.[1] Recent events indicate that the truth is far more painful.

The quarter-on-quarter drop in GDP accelerated from 3.3 percent to close 2008 to 4.0 percent to open this year. The annualized rate of decline worsened from a dreadful 12.7percent to a devastating 15.2 percent.[2] Incredibly, the Japanese economy is back to the same size it was 17 or 18 years ago.[3] For the first four decades of the post-war era, Japan enjoyed unmatched economic progress. For the last two, it has seen no progress at all. While the second quarter will almost surely show slower decline, the economy is heading in the wrong direction. Ongo-

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ing contraction through 2009 would push Japan further backward in time.

Rather than taking six years to reach the low point of the decline, it has taken more than 16—indeed, the Japanese economy may still have further to fall. The initial lost decade is directly linked to the present slump by Tokyo's continued clutching of a failed economic model.

Four Errors. Four connected factors account for Japanese economic weakness. It may be hard to believe, but in the early 1990s, Japanese policymakers were actually too confident. For several years it was apparently inconceivable that Japan could suffer a setback serious enough to warrant strong action.[4]

Throughout the lost decade, transparency in economic policy was an afterthought. A small group of bureaucrats was seen to have done a marvelous job behind closed doors. When failed projects and public confidence became issues, there was little motive or ability to openly evaluate policy, so consumers became cynical about the efficacy of government action and defensive in their behavior.[5]

Even now, fiscal waste continues. The initial response to the popping of the 1990s bubbles was to do nothing. This eventually gave way to wildly high deficit spending, which failed to rejuvenate the economy and resulted in the highest public debt burden in the OECD.[6]

It is reasonable to argue that Japan spent the money unwisely and greater returns to government spending were possible. It is not reasonable, however, to argue that simple Keynesian stimulus could have been effective if only a bit more money was spent.

Finally, there is a crippling problem with the economic model itself. A stunning, decade-long reversal should have prompted fundamental reform. Instead, Japan continued to emphasize external efficiency over a balanced economy. This approach seemed to pay off when exports led a resurgence of growth from 2002 to 2005. But stark export dependence is now a critical weakness.[7] Other countries face the consequences of export dependence as well, but none suffered the abject lesson Japan so studiously ignored.

What Japan Should Have Done. At least part of what Japan should have done is clear:

- Act immediately. Sudden financial contractions indicate serious distortions that must be addressed.
- Whatever the government's response, it should be subject to ongoing, sharp, and completely open scrutiny to see what changes must be made.
- Do not use public spending to try to stop an economic contraction, as it will only stretch it out.
- At some point in a slump, everything must be on the table. Even some long-term strategies, such as Japan's export obsession, must be modified or reversed.

Will Washington Learn? Like the never-ending stream of Japanese prime ministers, the Obama Administration is not responsible for the mess it

1. Derek Scissors and J. D. Foster, "Two Lost Decades? Why Japan's Economy Is Still Stumbling and How the U.S. Can Stay Upright," Heritage Foundation *WebMemo* No. 2307, February 23, 2009, at *http://www.heritage.org/Research/AsiaandthePacific/wm2307.cfm*.
2. Yuka Hayashi, "Japan's GDP Shrinks as Consumer Spending Feels the Pinch," *The Wall Street Journal*, May 21, 2009, at *http://online.wsj.com/article/SB124280029530738327.html* (May 28, 2009).
3. Organisation for Economic Co-operation and Development, StatExtract, Dataset 1: Gross Domestic Product, at *http://stats.oecd.org/wbos/Index.aspx?datasetcode=SNA_TABLE1* (May 28, 2009).
4. See Richard Koo, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession* (Hoboken, NJ: Wiley Press, 2009).
5. Gary Saxonhouse and Robert Stern, eds., *Japan's Lost Decade: Origins, Consequences and Prospects for Recovery* (New York: Wiley-Blackwell, 2004).
6. "Debt Burdens," OECD Observer, 2009, at *http://www.oecdobserver.org/news/fullstory.php/aid/2842/Debt_burdens.html* (May 28, 2009).
7. Kazuo Ueda, "Solving Japan's Economic Puzzle," *Far Eastern Economic Review*, May 2009, at *http://www.feer.com/essays/2009/may/solving-japans-economic-puzzle* (May 28, 2009).

inherited, but its response is, so far, charting a disastrous course.[8] Unlike Japan, America acted quickly to meet this financial shock. The U.S., however, risks repeating Japan's other mistakes—in some cases more profoundly.

The Obama Administration's performance on transparency—the stringent examination of government programs—is thus far poor. For example, TARP has been at the center of the response to the crisis and quickly moved beyond its stated, statutory bounds.[9] The Administration now suggests it be kept running for an unspecified period and with an increasingly ill-defined set of responsibilities.[10]

It should not be surprising, then, that America is replicating Japanese fiscal waste. The federal budget deficit for 2009 is expected to approach $2 trillion.[11] This is as much as the past five years combined, when federal spending was already excessive. Japan's experience demonstrates that deficits, no matter the size, are no solution. Rather, they are a crutch to avoid reform and excuse wasteful projects by claiming that the mere act of spending has inherent value.

The most important lesson from Japan is, as usual, the hardest. The American economy has under-saved and underinvested, pushed in that direction by long-term policies such as an anti-saving, anti-competitive federal income tax.

Unlike its Japanese counterpart, the U.S. government is considering sweeping, structural reforms. Unfortunately, these changes head in the wrong direction, threatening to make the American economy less competitive. The reforms being considered include imposing new distortions on energy and health care markets, economically destructive environmental policies, and implicit or explicit higher taxes on a wide range of businesses.

Lessons from Japan. The Administration and Congress must accept the extent of the crisis and the harmful long-term impact of many of the policies now being implemented or under consideration. The issue is not just this year. The Japanese example shows clearly that American economic vitality is not guaranteed. There are potentially devastating domestic and international consequences if, paralleling Japan, the U.S. economy is the same size in 2026 as 2009.

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8. A key difference is that Japan's need to restructure traces directly to government policy. In the U.S., imbalances result more because of openness to international goods and capital, leaving the American economy as consumer of last resort. If Japan, China, and Germany build economies on net exports, some economy or economies must be the net importer—most likely open economies such as the U.S.
9. Stuart M. Butler, "Time to End the TARP Bailout," Heritage Foundation *WebMemo* No. 2174, December 15, 2008, at *http://www.heritage.org/Research/Economy/wm2174.cfm.*
10. Matthew Jaffe, "Treasury Secretary Timothy Geithner Defends Planned Reuse of TARP Funds," ABC News, May 21, 2009, at *http://abcnews.go.com/Business/Politics/story?id=7648241&page=1* (May 28, 2009).
11. Andrew Taylor, "U.S. Red Ink Rising Even Higher, to $1.8T," Associated Press, May 11, 2009, at *http://finance.yahoo.com/news/White-House-Budget-deficit-to-apf-15199183.html?.v=8* (May 28, 2009).