What the U.S. Can Learn from Japan's Economic Policy Failure After the Crisis

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The earthquake and tsunami that hit Japan in March was an enormous tragedy. Thousands of people died and large segments of the country were decimated. Many suggested it was the greatest disaster to confront Japan since the Second World War. At the same time, in a strange sense, it also provided Japan with a great opportunity.

There would be an enormous need to rebuild the huge stock of infrastructure that had been damaged or destroyed in the disaster. According to official estimates, the cost of doing so would be at least ¥16 (approximately $200 billion), which is roughly equivalent to 3% of Japan's GDP. If this huge amount for reconstruction were spent in a short period of time, it would represent a substantial increase in aggregate spending that not only would repair most of the physical damage resulting from the earthquake and tsunami but also would provide considerable economic stimulus. Since the housing and land market bubbles burst in the early 1990s, Japan had suffered through "two lost decades" of general stagnation which had left it with large quantities of unused and under-used resources. There was the prospect that these resources could be now employed for the major tasks ahead.

The debate that ensued was predictable. One side argued that the country had no alternative but to do so at once. The need to rebuild was clearly overwhelming, and the country's focus should be directed at its people, communities and productive facilities. To start the process, government should borrow and spend now, and repay these loans from the additional tax revenues forthcoming from a recovered and rebuilt economy.

The other side's position was equally predictable.

Japan’s “two lost decades” had left the country “broke” and it just could not afford to spend such a huge amount needed for rebuilding right away. Instead, it would do so as public funds became available by increasing taxes and/or reducing other public expenditures. In the meantime, private funds would be utilized for reconstruction.

We are now nearly four months down the road and can see who seems to have won the argument. To this point, the approved additional government spending for rebuilding has been a mere ¥4 trillion (less than $45 billion), which is only about one-fourth of the lowest estimate made of total damages. Furthermore, political instability and uncertainty, aggravated by Prime Minister Kan’s announcement of his intended resignation, may well prevent an additional spending bill from passing the Diet (Parliament) anytime soon.

While supply side concerns, such as the production disruptions in both automobiles and electronics appear to be dissipating, demand side problems remain. Despite the need for government outlays to promote reconstruction, they have not been forthcoming in sufficient magnitudes to meet the tasks at hand. Aggregate spending has remained below levels needed to promote economic growth, and it is not surprising that the IMF has reversed its recent forecast for Japan and now predicts a continued shrinking economy in 2011.

Throughout government circles in Tokyo, there is fear that additional public spending, designed for reconstruction and/or economic stimulus, would trigger further downgrading of Japanese government bonds, which in turn would upset the financial markets and lead eventually to higher interest rates. From this perspective, to protect bondholders, the government should retrench and not expand its efforts, regardless of the effects on reconstruction and the real economy.

What is apparent is that in Japan as in so many other places, policy-makers permit financial matters to take precedence over those affecting the real economy. Austerity is enforced to maintain stable prices and interest rates regardless of their impact on output and employment.

Although this story comes from the Japanese experience, it also applies to the current US debate over the government taxes and expenditures; a debate that has become critical because of its political linkage to the government debt ceiling crisis.

Those who argue for major cuts in government expenditures rarely mention the negative impacts of such cuts on the economy and employment but instead stress the need to demonstrate long-term solvency regardless of their current consequences. They maintain strenuously that we are "broke" and simply can't afford increased or even current government outlays, regardless of their purposes. Moreover, they suggest that further borrowing will simply impose an unconscionable burden on our children and grandchildren when the debt incurred must eventually be paid. They also stress the monetary consequences: interest rates will rise and inflation will reappear.

The reality in the US economy is strikingly different from that portrait. Unemployment remains stubbornly high with no visible downward trend, while both interest rates and inflation are low by historical standards. Indeed, the US could well be in the midst of its own "lost decade." There is a reasonable expectation that economic activity in the private sector alone will not be sufficient to employ our large and growing labor force. And these prospects are exacerbated by limited tax revenues received by the states, which have led many of them to reduce the numbers of state employees.

In such circumstances, the Japanese experience teaches us that simply waiting for the economy to right itself without taking forceful government action can lead directly to stagnation and continued economic decline. Without lower taxes and increased government spending, the US could be following Japan's path towards a "double-dip recession" or even "two lost decades".

To be sure, as many would remind us, lower taxes and/or increased government spending lead directly to larger federal deficits that in turn could lead eventually to higher interest and inflation rates. Even before that occurs, US Treasury bonds could be downgraded by the ratings agencies, as occurred in Japan, resulting in lower bond prices and higher long term interest rates. But again, there are lessons to be learned from the Japanese experience. In that country, both short-term and long-term interest rates as well as inflation rates have remained historically low despite Japan's accumulated debt to GDP ratio that is the highest in the developed world. Such arguments ignore the roles played by central bankers in both countries. Interest rates can be kept low even when government deficits, needed to stimulate the economy, are large.

Stanford professor John Taylor makes a related argument. He writes in a recent editorial that substantial spending cuts are needed, even in the face of a tepid economic recovery and despite national unemployment rates that exceed 9%, not for their effects currently but rather to send a message about government spending in the future. His predominant concern is with "taking actions today that are inconsistent with good policy in the future." [Wall Street Journal, June 2, 2011] So important is this position to him that he would rather see the federal government default on its debts by not having the Congress raise the debt ceiling limit than have it fail to send the right message on government spending regardless of their purposes and effects.

Keynes once said that "in the long run, we are all dead." That quip should not be taken to mean that long run issues are unimportant; of course they are not. What it does mean is that short run concerns like those regarding the current unemployment levels, along with the failure of our economy to rebound in an acceptable manner, are not unimportant details. And we should not derail policies designed to ameliorate current problems because of a fear that bondholders and investors somewhere might be displeased. **In the end, capital market flows are determined by what happens in the real economy, not the other way around; and it is the real economy where our policy concerns should lie.**

Policy-makers in Japan have been excessively concerned about financial issues and have let the real economy continue to stagnate. We need to be concerned that this same result does not happen in the United States.