Japan's Lesson for America

BY RICHARD C. KOO

A comparison of deflationary woes.

The concern over possible deflation in the United States and many other parts of the world has sparked a renewed interest in the Japanese experience, which has proven, to use Alan Greenspan's words, that it is possible to have a deflation without a gold standard. Many puzzled observers, however, including the Fed chairman, have resorted to the Japanese cultural aversion to bankruptcy and resultant increase in zombie companies as the explanation for Japan's deflation. The implication is that the United States will not face the same problem because it will not tolerate zombie companies.

The actual cause of deflation, however, is quite straightforward and has nothing to do with zombie companies or cultural differences. Furthermore, the same factor that pushed Japan into deflation is not only slowing the U.S. economy, but remaining equally unnoticed.

Deflation is caused when a large number of companies all at the same time decide to shift their priorities from their usual profit maximization to strengthening their balance sheets. Such a shift, however temporary, disrupts the normal workings of the economy because the corporate sector stops taking the funds the household sector has saved, even with very low interest rates. With no one borrowing, the entire savings of the household sector together with the debt repayment of the corporate sector just sits in the banks unused, effectively becoming the economy's deflationary gap.

Such a nationwide shift in corporate priorities typically happens after a bubble when companies see their asset values falling sharply relative to their liabilities. Companies engaged in repairing balance sheets, however, are most reluctant to publicize their problems. Their quietness, in turn, makes the detection of the problem much more difficult for the policymakers.

THE JAPANESE EXPERIENCE

In the case of Japan, the shift in corporate priorities happened after the massive drop in asset prices—especially those of commercial real estate—following the bursting of the bubble in the early 1990s. The resultant damage to their balance sheets left companies with no choice but to reduce debt. With their main line of business and cash flow from

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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Washington, D.C. 20006
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building cars and cameras largely intact, the Japanese companies all began to use their earnings to pay down debt.

As a result, the Japanese corporate sector has not only stopped borrowing the money the household sector has saved, but also been a net supplier of funds to the banking system and capital market to the tune of ¥20 trillion per year through debt repayment. This means the entire savings of the household sector together with the debt repayment of the corporate sector have become the leakage to the income stream, effectively becoming the economy's deflationary gap. This gap is nearly 8 percent of Japan's GDP. This means the economy will continue to shrink 8 percent every year unless action is taken to stop the vicious cycle from taking hold.

In this unusual environment, a monetary policy remedy is largely ineffective. This is because, with all players minimizing debt in order to repair their balance sheets and no one borrowing money, money supply cannot be increased since the liquidity provided by the central bank cannot leave the banking system. Furthermore, in order to stop corporate debt repayment, the real driver for deflation, the often-proposed inflation targeting or central bank purchases of other assets will not be effective unless the central bank promises to bring back and maintain bubble-level asset prices. But that means a return to a Nasdaq index of 6,000 or the Imperial Palace in Tokyo being worth the entire State of California, an impossible proposition.

Since the government cannot tell the private sector companies *not* to repair their balance sheets, the only thing the government can do is to do the opposite of the private sector. In other words, the government must borrow and spend the money the household sector has saved but the corporate sector did not borrow. This is needed in order to both stabilize the economy and keep the money supply from shrinking as a result of the private sector paying down debt.

And that is exactly how Japan has managed to stay afloat in spite of a loss of wealth comparable to what the United States suffered during the Great Depression in the 1930s. Instead of losing half its GDP and 40 percent of its money supply as the United States did under President Hoover seventy years ago, Japan has managed to maintain stability for both because of the prompt fiscal response that filled the deflationary gap each year before the vicious cycle was allowed to start. Although the pork-barrel politicians (or their opponents, for that matter) never understood what they were actually doing, by keeping the economy stable, they have allowed companies to pay down debt so much that, for most companies, their job of repairing balance sheets will be finished in just a few more years. This is a remarkable achievement in a country where commercial real estate values have fallen 85 percent from their peak levels.

Once the corporate balance sheets are repaired, it will be the government's turn to repair its own balance sheet. But such a shift should not be made before the majority of companies have returned to a forward-looking mode, which is not yet the case. In this sense, Prime Minister

The Role of Government

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When a large number of companies shift their priorities from profit maximization to debt minimization all at the same time, a fallacy of composition problem is created where **Adam Smith**'s invisible hand works in the opposite direction by shrinking both the economy and the money supply. In this unusual situation, the government—the only player outside the fallacy of composition—must have the courage to do the opposite of the private sector by borrowing and using the excess savings of the private sector if a major economic disaster is to be avoided.

—R. Koo

After the Enron affair and the passage of the Sarbanes-Oxley Act, an impeccable balance sheet for U.S. companies is no longer a luxury but a necessity. At the same time, the last thing these companies want is public attention to the fact that they may have balance sheet problems.

Nippon Survival Strategy

Japan has managed to stay afloat in spite of a loss of wealth comparable to what the United States suffered during the Great Depression in the 1930s. Instead of losing half its GDP and 40 percent of its money supply as the United States did under President **Herbert Hoover** seventy years ago, Japan has managed to maintain stability for both because of the prompt fiscal response that filled the deflationary gap each year before the vicious cycle was allowed to start.

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Koizumi's reluctance to use sufficient fiscal stimulus to fill the gap when companies are still paying down debt has been the single most important reason for economic weakness in Japan.

THE U.S. CHALLENGE

This lesson of Japan's encounter with deflation is highly relevant to the U.S. situation today because, in spite of the lowest interest rates in fifty years, corporate capital expenditure activity has failed to revive. Indeed, a number of surveys of business executives have indicated that U.S. companies are actually planning to reduce capital expenditures in the coming year. This means a much-awaited pickup in business investments before the boom in residential housing loses its forward momentum may not be forthcoming. Furthermore, in spite of super-low interest rates, the savings rate of the household sector has been rising instead of falling, a highly unusual and disturbing phenomenon.

Corporate leaders have argued publically that there has been too much uncertainty, both in geopolitics and accounting rules, for them to make capital expenditure decisions. However, surveys taken after the Iraq conflict show very little improvement in business sentiment. Furthermore, the argument that companies cannot invest because of accounting rule changes makes little business sense. After all, except in very special circumstances, an investment project that makes money still makes money no matter what the accounting rules are.

The real reason for corporate reluctance to invest is likely to be concern over balance sheets. After the information technology bubble and its excesses, these companies want to make sure that their balance sheets are impeccable before outsiders, including the Securities and Exchange Commission, examine their financial statements. After the Enron affair and the passage of the Sarbanes-Oxley Act, an impeccable balance sheet for U.S. companies is no longer a luxury but a necessity.

At the same time, the last thing these companies want is public attention to the fact that they may have balance sheet problems. Thus, corporate leaders are likely to use uncertainties over the Iraq war or accounting standards as an excuse for not investing when in fact they have no intention of increasing investments until their balance sheets are in order.

Policymakers in Washington, however, need to be fully aware of this tendency on the part of corporations. They must be able to see through the excuses and realize that this is a balance sheet recession (instead of an ordinary recession) so they can take appropriate measures to counter the deflationary pressures coming from the corporate efforts to repair their balance sheets.

More specifically, in a balance sheet recession, public spending is a more effective remedy than tax cuts. This is because when there is a certain amount of demand gap that needs to be filled, it is difficult to determine in advance how much tax cut is needed to fill that gap. When so many households and companies are trying to rebuild savings or repay debt, the tax cut needed may be many times the size of the gap to make sure that the cut generates sufficient demand to fill the gap. When the size of the budget deficit is already a political issue, a tax cut large enough to fill the gap may not be feasible. When the economy is in a balance

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sheet recession, therefore, public spending is more efficient per dollar of budget deficit than tax cuts in stabilizing and stimulating the economy.

Of course there are many differences between the U.S. situation today and the Japanese situation ten years ago. In particular, the boom in the residential real estate market is keeping the U.S. economy going, a form of economic stimulus the Japanese were never able to enjoy. However, there is a real question as to the sustainability of the housing boom now that interest rates have fallen as low as they have.

Moreover, the fact that the household savings rate is rising in the United States means that the U.S. economy is squeezed from both the household sector increasing savings and the corporate sector reducing investments. This double squeeze is something the Japanese never had to worry about as Japan's savings rate actually fell during the last ten years. Although the damage the U.S. economy has sustained so far is probably less than the 8 percent GDP gap that Japan is facing now, any deflationary gap left unfilled can start a vicious cycle that can make life difficult for everybody.

CONCLUSION

Balance sheet recession is both inaudible and invisible, because those who know the real driver of the recession are least disposed to share that information with the outside world. With a lower dollar, lower taxes, lower interest rates, and lower oil prices, the U.S. economy should be recovering strongly. The fact that it is still having difficulties suggests that some unusual factors are working behind the scenes. In the aftermath of the information technology bubble and its excesses, it is likely that the unseen factor is the corporate desire to strengthen balance sheets overcoming the usual drive for profit maximization.

Prime Minister **Junichiro Koizumi's** *reluctance to use sufficient fiscal stimulus to fill the gap when companies are still paying down debt has been the single most important reason for economic weakness in Japan.*

Although repairing balance sheets is the right and responsible thing to do for individual corporations, when a large number of companies shift their priorities from profit maximization to debt minimization all at the same time, a fallacy of composition problem is created where Adam Smith's invisible hand works in the opposite direction by shrinking both the economy and the money supply. In this unusual situation, the government—the only player outside the fallacy of composition—must have the courage to do the opposite of the private sector by borrowing and using the excess savings of the private sector if a major economic disaster is to be avoided. Waiting for monetary stimulus to turn the economy around may only result in disappointments in November 2004. ◆

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