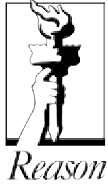

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Avoiding an American "Lost Decade": Lessons from Japan's Bubble and Recession

By Anthony Randazzo, Michael Flynn and Adam B. Summers

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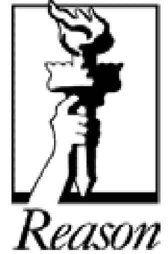

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Table of Contents

1 **Introduction**

3 **Bubble Causes**

3 A. Overly-aggressive behavior of financial institutions and poor risk management that ignored basic economic trends

6 B. Monetary policy errors

9 C. Other destructive government policies

11 **Recession Responses**

11 A. Government lending to poorly managed firms

12 B. Government developing conflicting interests

13 C. Short-term, static political vision and harmful monetary policy

15 D. Tax policy errors

16 E. Government spending through infrastructure "investment"

18 **Conclusion**

20 **About the Authors**

21 **Related Reason Foundation Studies**

22 **Endnotes**

Part 1

Introduction

Is the United States about to follow Japan into a decade of economic stagnation? After Japan's asset bubble burst in the early 1990s, its economy took a sharp downturn, prompting government officials to extend massive loans to banks and businesses while investing in infrastructure—much like the activity and proposals floating around the U.S. today. The results led to a decade of economic malaise and recession. The causes of Japan's bubble were also very similar to those of the American housing bubble and ensuing recession. Given the parallels, it is important to look at what the United States can learn from the Japanese experience to avoid similar economic struggle.

The Japanese government's response to their recession was a wide-ranging mix of fiscal policy, monetary policy and denial. In the face of rapid economic growth, the Bank of Japan erratically shifted interest rates, first up and then sharply down. The Ministry of Finance downplayed the degree of toxic debt banks were left holding when the bubble burst and instead encouraged more lending. And in an attempt to restart growth and stem unemployment, the government spent massive amounts of money on public works projects and stimulus checks to citizens. All of this carried a common thread: government intervention in the market.

Like the governing sentiment in Washington during this recession, the Japanese government was convinced it had to act to save the market when that country's asset bubble burst. But easing credit rates created artificial demand. Government loans and stimulus spending weren't economically productive and only served to increase the nation's debt and prolong the economic malaise. Worse, businesses spent critical time on the sidelines, waiting for government bailouts, instead of consolidating their losses, clearing their balance sheets of bad investments, and reorganizing. The businesses avoided hard decisions, but they reaped a harsh economic environment.

The ensuing recessionary period in Japan would come to be known as the "Lost Decade," and was characterized by an average economic growth rate of less than 1 percent.[1] Unfortunately, there is evidence that the crisis would have been resolved sooner if the Japanese government had simply stayed out of the market's way.

The United States has started down a similar road. After the federal takeover of Fannie Mae and Freddie Mac and the bailout of AIG, banks and troubled firms are less likely to make hard decisions concerning their balance sheets and more likely to wait for a government bailout. The government intervention—and the expectation of additional government action—removed any

incentive firms had to independently clean up their balance sheets by selling their bad assets. Why accept pennies on the dollar if a deep-pocketed new bidder (i.e., the government) may enter the scene? As the Japanese experience shows, as long as the government is an active participant in the market, firms will accept government support and put off the inevitable financial reckoning. Ultimately, this restricts economic growth and creates a cycle of stagnation.

Government intervention during a recession generally results in the opposite of its intended effect: dragging out the economic malaise, preventing economic recovery and making the financial situation worse. The United States experienced this during the Great Depression as New Deal policies of spending, price setting and corrupt intervention prolonged the economic downturn. But today's recession even more closely parallels the cause and response of Japan's recession in the 1990s. Ultimately the lesson of the Japanese Lost Decade is one that the United States must learn to avoid extending the current recession.

Part 2

Bubble Causes

The Japanese asset bubble grew out of an economic boom that began in the mid-1980s and lasted until the early 1990s. By November 1986, after several years of slow growth, eased monetary policy fueled a boom of domestic investment and increased consumption. With access to easy credit, the economy shifted from its traditional economic activities, such as agriculture, to a higher-value technology-based economy, chiefly in telecommunications, computers and finance.

This demand for new and better technology products, combined with increased living standards, fed an asset investment craze referred to as the Heisei boom, named for the then-reigning emperor. The value of the yen increased during this time, due primarily to the 1985 Plaza Accord—an international conference in New York that changed the value of the yen against other currencies—and Toyko became a major financial services center. The Japanese Stock Market grew exponentially, with the Nikkei 225 (similar to the Dow Jones Industrial Average) more than tripling between 1985 and the end of 1989, but it was a bubble that was about to burst.

In a 1991 article, Kenneth Courtis, then senior economist for Deutsche Bank Capital Markets in Tokyo, painted a clear picture of what many assumed the Japanese economy was before the extent of the crisis was clear: "Although Japan is likely to experience a slowdown toward the end of this year and early next year, the outlook beyond is bright."[2] Shortly after this was published Japan realized any brightness was an illusion and that its economy was in trouble.

The causes of the Japanese asset bubble and American housing bubble are eerily similar. The behavior of the respective governments, their financial systems, and investor attitudes leading into and surrounding the bubble collapses parallel in three critical ways:

A. Overly aggressive behavior of financial institutions and poor risk management that ignored basic economic trends

Both in Japan and the United States, excessively optimistic expectations of future economic development led to poor investment decisions and a pervasive denial of obvious bubble trends.

Japan

The Japanese asset bubble was fueled by a 51 percent average growth rate in housing prices and an 80 percent increase in average commercial property values between 1985 and 1991. This rapid growth trend created an overconfident investment culture in Japan that was not prepared for any kind of correction. Since the peak, asset values have fallen over 40 percent (as of 2008).[3]

Largely due to the 1970s export boom, Japan was flush with capital in the 1980s and investors were all looking for a stake in the country's growing role as a major player in the world financial system. In the preceding years, individuals and firms had built up a large pool of savings and began investing those resources in real property. The rapid rate of investment pushed the value of these lands, buildings and other capital investments exponentially higher, encouraging even more investment, and, in turn, speculation in the belief that values—and returns—would go ever higher.

Riding this asset appreciation, Japanese banks borrowed nearly ¥200 trillion (yen) ($3.4 trillion in today's dollars) from foreign markets. This sum was in turn lent extensively throughout the Japanese economy. The lending was further fueled by inadequate debt-to-equity requirements that created perverse lending incentives. By 1991 Japanese banks had reserves of only ¥3 trillion to cover the ¥450 trillion they had lent out.[4] Normally, this would have signaled trouble. But the economic climate in Japan back then is often described as "euphoric"; prudence was not a hot commodity.

The causes of the Japanese asset bubble and American housing bubble are eerily similar.

The United States

The American housing bubble was arguably bigger, though values have yet to fall as much as Japan's. Between 2000 and 2006, average home prices in the U.S. grew by 90 percent, and commercial property values expanded by the same rate. Since the peak, home prices nationwide have declined around 20 percent, although certain regions have experienced sharper falls. Some believe home prices could drop as much as 10 percent more.[5]

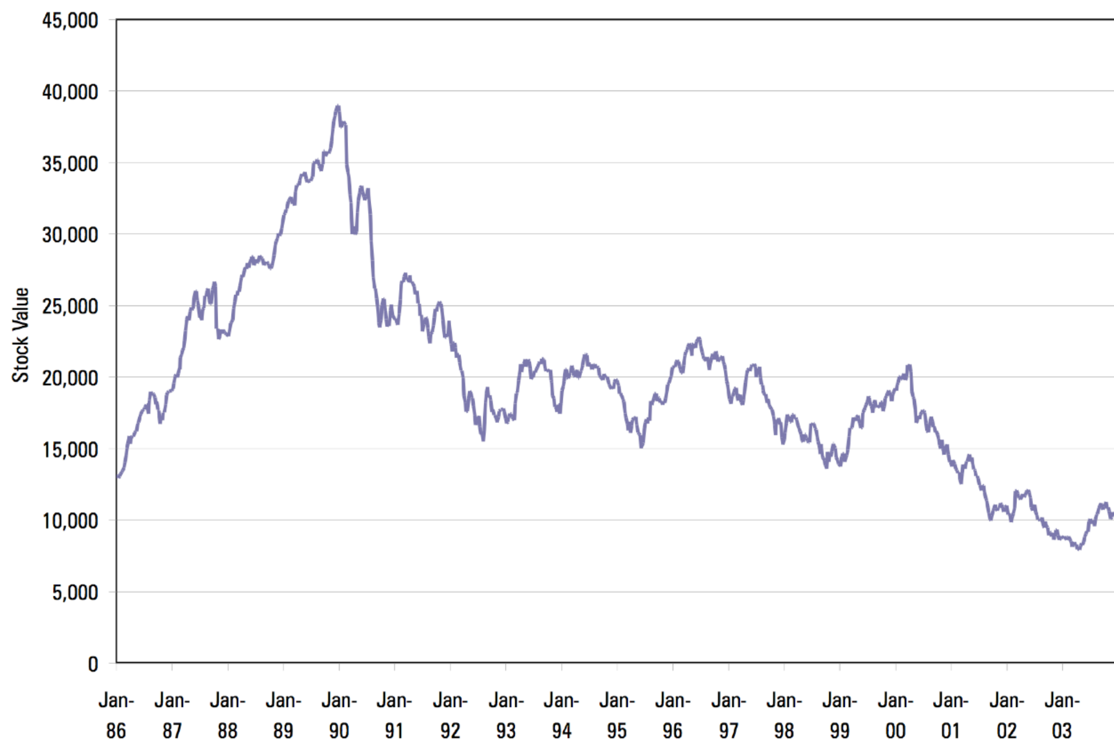
After the dot-com bubble burst and interest rates began falling in the U.S., American investors began looking for new means of getting a quality return on investment. At the same time, Wall Street was aggressively "securitizing" home mortgages by bundling loans and reselling them to investors, including new subprime mortgages increasingly available to home buyers with spotty credit histories. These mortgage-backed securities contained a combination of traditional and subprime mortgages. Because of this, they received both a high rating from the credit rating agencies because of the traditional mortgages, as well as a higher rate of return because of the subprime mortgages.

As housing prices climbed, rates of return on investment increased. The investment patterns suggest that most Americans thought climbing stock value and AAA ratings on securitized mortgages (many that included a portion of subprime mortgages) were safe financial investments. This overconfidence led most major Wall Street firms to increase their capital ratios, taking on more debt and decreasing the amount of cash on their balance sheets. By 2007, the investment bank Lehman Brothers was leveraged 30 to 1, meaning just a 3.3 percent decline in asset values would wipe out its capital, an event that happened very quickly.

Stock Market Bubbles

In both the U.S. and Japan, the rapid rise in property values also fueled gains in the stock markets. The Japanese stock index Nikkei 225 rose from 13,000 in 1986 to an intraday high of 38,975 by the end of 1989 (see Figure 1). However, the implosion of the property market sent the index crashing, hitting 15,025 by July 1992 and continuing a steady decline throughout the Lost Decade. In April 2003, the Nikkei fell to 7,603, less than 20 percent of its peak.

Figure 1: Nikkei 225 (January 1986 to December 2003)

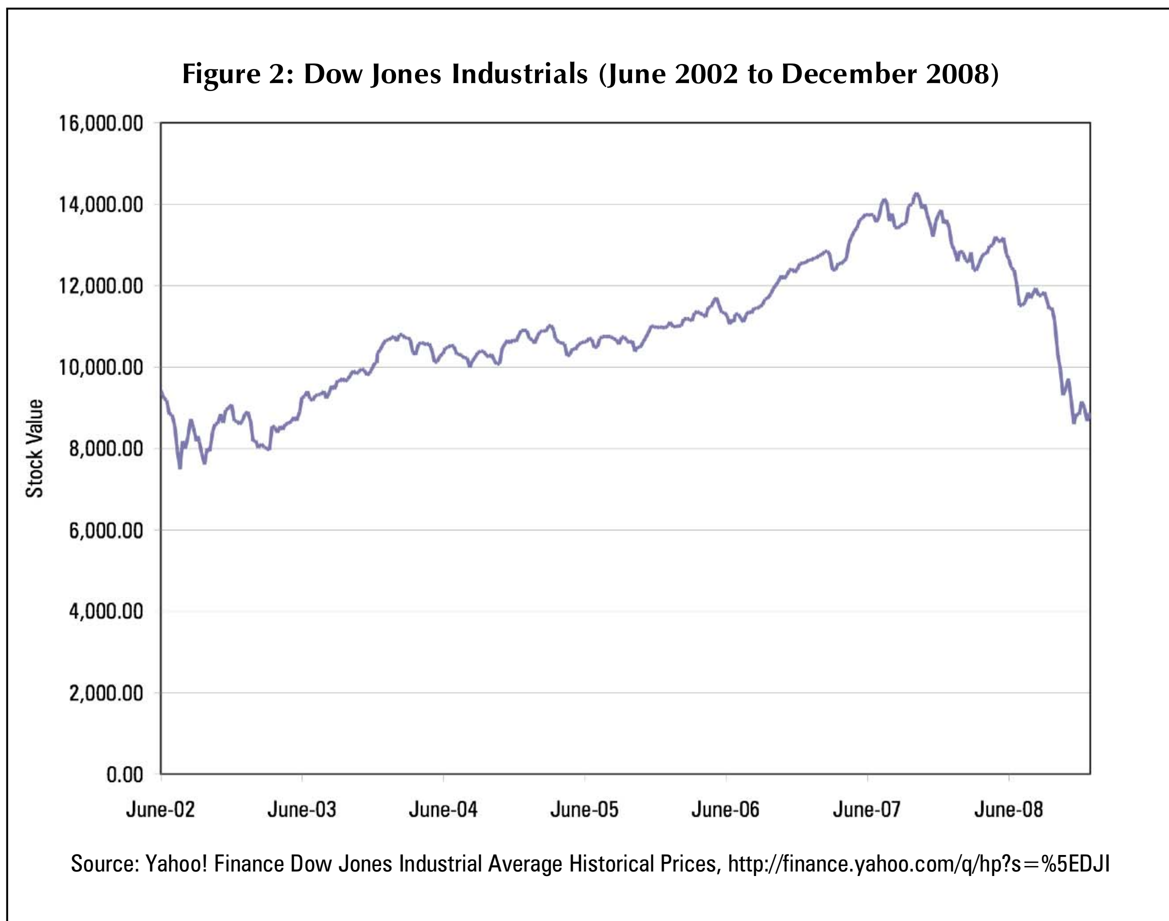


Source: Yahoo! Finance Nikkei 225 Historical Prices http://finance.yahoo.com/q/hp?s=%5EN225

In the same way, the Dow Jones went from 7,489 in July 2002 to an intraday high of 14,115 in October 2007 (see figure 2). Since that high point, the market began a modest decline, reaching 10,850 on September 30, 2008 and then plummeting to 7,552 by November 20.

The quick run-up in stock valuations, both in Japan and the U.S., lured people to invest money that they did not have. The result was inadequate risk management, over-leveraged investments and fragile capital reserves. Debt-to-equity ratios reached dangerously imprudent levels of 30 to 1 or more. Investors did not adequately plan for any contingency other than continued high growth, and largely ignored all who warned that such growth was not sustainable.

Figure 2: Dow Jones Industrials (June 2002 to December 2008)



Source: Yahoo! Finance Dow Jones Industrial Average Historical Prices, http://finance.yahoo.com/q/hp?s=%5EDJI

B. Monetary policy errors

Though the financial institutions played a key role in the booms and inevitable busts in Japan and the U.S., a critical root cause of both was monetary policy intervention. In both cases, the central bank helped to set off a boom in asset prices by spurring an unsustainable credit expansion which drove interest rates to artificially low levels. This encouraged individuals and businesses to take on debt that they would not otherwise accept and make investments that they would not otherwise make.

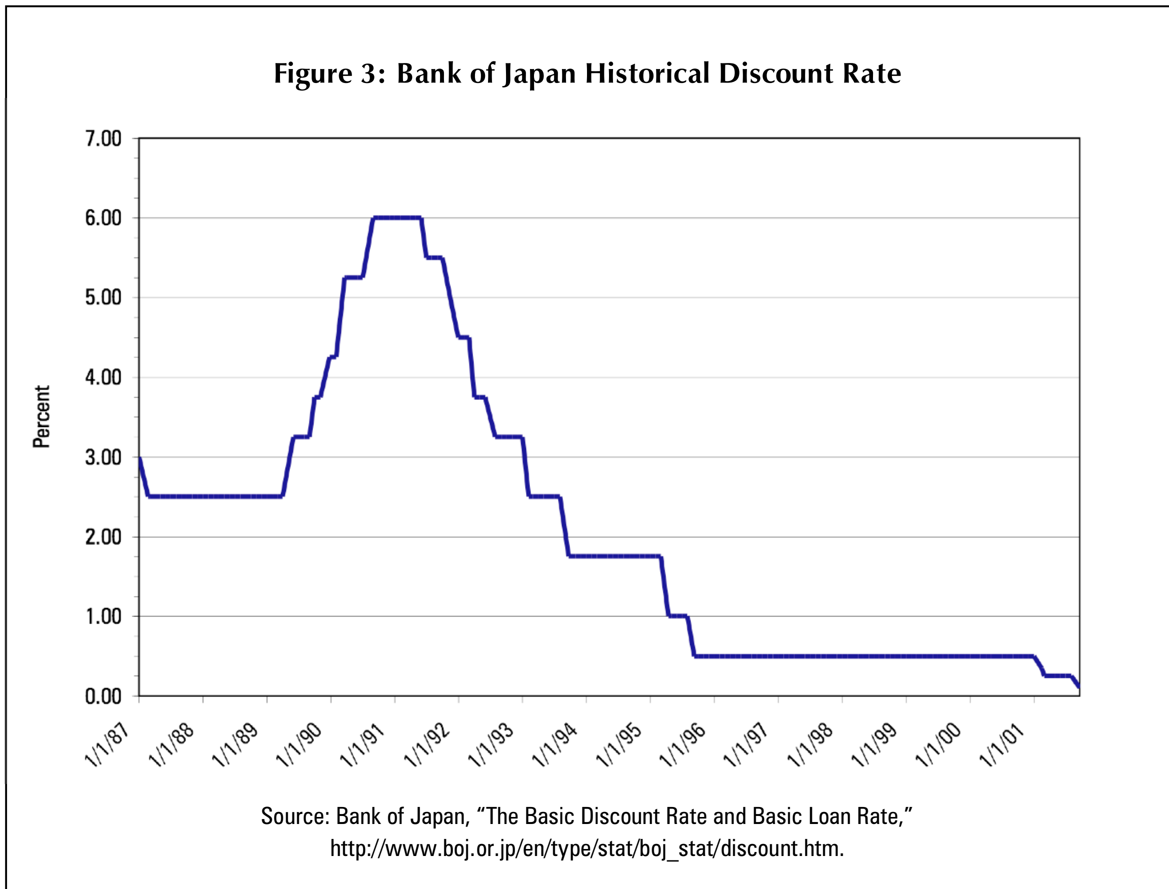
When a central bank inflates the money supply and drives interest rates below those that would exist without government intervention, this sends a false signal to businesses to borrow and invest more in capital projects and goods than they otherwise might. Similarly, consumers respond to the signal by taking on higher mortgage and/or credit card debt, saving less and spending more. Credit binges like this cannot last forever; when interest rates are increased again the malinvestments are revealed, and it becomes painfully clear that much of the credit that has been issued cannot be paid back.

Japan

Between January 1986 and February 1987, the Bank of Japan (BOJ) cut the discount rate from 5 percent to 2.5 percent, leading to an increase in real estate and stock market prices. Realizing a bubble was forming, the BOJ then raised rates five times in 1989 and 1990, to a high of 6 percent. The increase in interest rates revealed that many investments were built on extensive, unsustainable debt, and stocks began to slide.

As a recession began to set in after the 1990 stock crash, Japan responded by reversing its monetary tightening, cutting rates to 4.5 percent in 1991, 3.25 percent in 1992, 1.75 percent during 1993-1994, 0.5 percent during 1995-2000, and as low as 0.1 percent in September 2001 (see Figure 3).[6]

Figure 3: Bank of Japan Historical Discount Rate



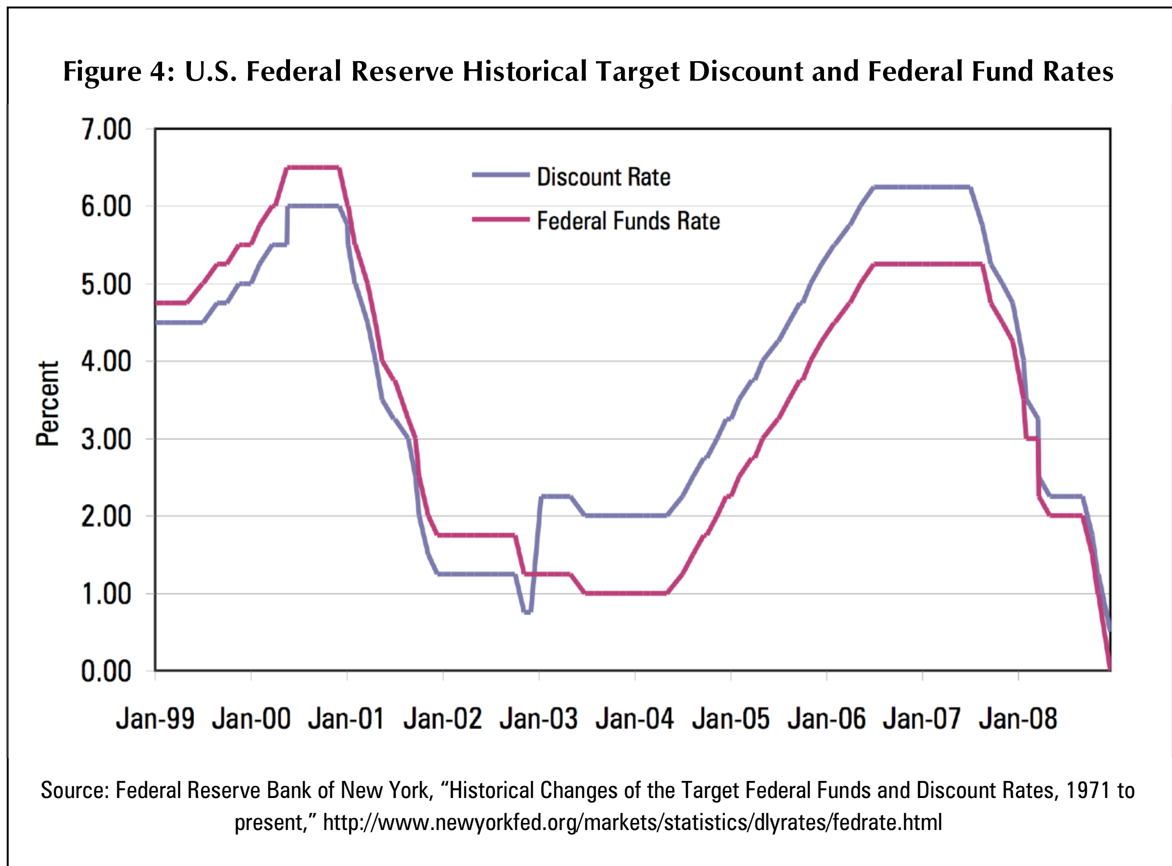
Source: Bank of Japan, "The Basic Discount Rate and Basic Loan Rate," http://www.boj.or.jp/en/type/stat/boj_stat/discount.htm.

The Unites States

A similar pattern emerged in the United States during the 2000s, as the Federal Reserve (Fed) drove rates down in the wake of the bursting dot-com bubble before reversing policy starting in the summer of 2004. The target discount rate was then increased from 2 percent to 6.25 percent over two years. Since June 2006, the Fed has cut the discount rate 12 times, lowering it to the current 0.5 percent rate. Additionally, during this time, the federal funds rate was cut from 5.25 percent to the present 0-0.25 percent target range (see Figure 4).[7]

U.S. Federal Reserve Chairman Ben Bernanke has repeatedly stated that he sees interest rate cuts as a way to "support growth and to provide adequate insurance against downside risks."[8] In both the Japanese and American cases, policymakers believed that lowering interest rates would make credit easier to obtain, thus recreating the environment that had spurred economic growth. But this meant that the supposed cure for the bubble created by easy credit was to extend *even more easy credit*. Unfortunately, this only perpetuated the distortion of economic decisions and prevented savings, investment and consumption from realigning with true preferences, as opposed to the illusory ones created by easy credit and artificially low interest rates. The important lesson to take away is that when monetary policy is used to "smooth" or "tweak" the market, it inevitably causes unintended consequences that, in some cases, can be very damaging to long-term economic growth.

Figure 4: U.S. Federal Reserve Historical Target Discount and Federal Fund Rates



Source: Federal Reserve Bank of New York, "Historical Changes of the Target Federal Funds and Discount Rates, 1971 to present," http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html

C. Other destructive government policies

Fiscal policy and the regulatory structure of both Japan and the United States played a role in the creation of, and eventual collapse of, the asset and housing booms. There is currently a robust debate over whether the American crisis is rooted in too much or too little regulation. But this misses a key point: the role that existing regulations played in spawning the crisis.

Capital Reserve Requirement Errors

In 1988, the Basel I Accord set new capital requirements for Japanese banks and banks around the world. However, the requirements were focused on loan amount and did not factor in the debt's underlying risk. In other words, a loan to a sound borrower required the same percentage of capital to be set aside as an equal amount lent to a high-risk borrower (largely due to loopholes in the system). There was already a developing atmosphere of heavy lending and insensitivity to risk, but the inadequate Basel requirements rewarded firms for making loans to shaky borrowers because they could charge higher rates of interest than a loan to a safe borrower.[9]

When monetary policy is used to "smooth" or "tweak" the market, it inevitably causes unintended consequences that, in some cases, can be very damaging to long-term economic growth.

The main problem was not necessarily that the requirement was too low, but rather that it created a false sense of security for investors and lenders. Banks were meeting their legal requirements, though it was never clear what kind of debt they were holding capital to cover. Had banks simply set their own requirements, published those requirements to make that information public, and competed with other banks for those customers seen as "the most secure," many more banks would likely have been protected than under all the regulations of Basel I.[*]

In the United States, when calculating a firm's reserve requirements, many assets are required to be "marked-to-market," i.e. valued at the price the asset could be sold for immediately. If asset values start falling, firms must scramble to find capital to maintain their reserves. The collapse of Fannie Mae and Freddie Mac suddenly devaluing mortgage-backed securities meant banks holding large percentages of these assets had to come up with millions in cash overnight. Many of the worst or

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[*] The problems with Basel I recommendations were widespread, as it has also been blamed for triggering the 1997 Asian financial crisis; Basel II, initially published in 2004, was largely an attempt to update standards and correct errors in the first accord.

most toxic mortgage-backed securities could not be sold immediately because they had no benchmarkable value. They were, in effect, worth nothing for the time being.

The market needed time to reassess the mortgage market, given the new information it was facing from the Fannie and Freddie debacle. In the meantime, banks had figures on their asset sheets go from millions of dollars to zero. Unable to find sufficient capital to meet the mark-to-market requirements, institutions such as Lehman Brothers, Washington Mutual and Citigroup fell prey to their debt. A temporary easing of the mark-to-market regulations would have bought firms precious time to recapitalize their balance sheets in a more stable manner. The banks still would have lost money, but they might not have gone bankrupt, causing a negative ripple effect throughout the economy.

Government Housing Policy

Both Japan and the United States had explicit government policies that encouraged an unhealthy acceleration in land and housing prices. A 2003 report from the Bank of Japan blames taxation and regulatory policies for an unnatural rise in asset values.[10] And American Federal Housing Administration policies have for years encouraged big expansions in mortgage lending, including subprime lending, particularly through Fannie Mae and Freddie Mac. This was done to expand homeownership for low-income families. Such policies span administrations of both political parties, from the Community Reinvestment Act enacted during the Carter administration in 1977 and strengthened during the 1990s under the Clinton administration to President George W. Bush's efforts to create a "homeownership society." This had two big impacts. First, it greatly increased the number of buyers, driving up housing prices. It also provided mortgages to a large number of people who had a high risk of default.

American Bankruptcy Laws

Existing U.S. bankruptcy regulations have also contributed to the crisis. Exclusivity clauses in the bankruptcy process allow firm management at least 18 months to reorganize, sell assets and restructure debt. However, during this period, the firm's creditors can be shut out of the process, making them uncertain that they can recoup their invested capital. Adjusting this law to give creditors some rights in the restructuring process would encourage confidence in the market for investors.

Though there are other harmful regulations, this paper is not an examination of American or Japanese regulatory policy in detail. Rather, these examples have been presented as a sample of the negative effects well-intentioned regulatory policy can have on an economy.

Part 3

Recession Responses

By early 1992, realizing that the economy was not going to rebound quickly, the Japanese government rushed through the first recession-fighting stimulus package. It was to be the first of many and an embarrassment for the emerging economic giant. Government spending and loans over the next several years propped up failing Japanese financial firms, but their lack of vitality and perpetual operating losses only earned the companies the moniker "zombie businesses."

Given the similar source of its bubble, U.S. federal officials should take a careful look at how Japan responded to its crisis—with policies that led to the Lost Decade, over ten years of recession and stagnation—to ensure the United States does not duplicate those mistakes:

A. Government lending to poorly managed firms

The Bank of Japan tried to ease economic pains during their downturn through the 1990s by loaning large amounts of money to businesses. However, the attempts to recapitalize the market ignored underlying management problems in the dying firms. It was a costly mistake.

According to Shigenori Shiratsuka, Deputy Director and Senior Economist at the Bank of Japan, even though firms became unprofitable, the government encouraged lending to them to prevent losses from materializing.[11] There were also widespread concerns about failing firms increasing unemployment.

Further complicating matters, banks and companies found a way to game the government's intervention. Banks would lend firms money at cheap rates and then the companies would turn around and lend the banks back their own money at a slightly higher interest rate to help balance the capital reserve ratios.[12]

The intense lobbying from special interest groups representing various sectors of the Japanese economy perpetuated the ill-fated loans and funneled government money to zombie businesses. Shiratsuka warns that "under such circumstances, loans to unprofitable firms become fixed and funds are not channeled to growing firms, holding down economic activity."[13]

The United States has already begun engaging in this practice, lending billions of dollars to financial institutions and buying up billions more in bank equity in an effort to recapitalize the marketplace. However, through this practice the government has been keeping poorly managed firms alive using taxpayer money. Just months after a $25 billion investment in Citigroup, and signaling its confidence in the firm by supporting its bid for defunct Wachovia (which was ultimately bought by Wells Fargo), the government had to step in with a second bailout of $20 billion after a negative analysis of Citigroup's obligations. The analysis had caused the financial sector to lose whatever confidence it had left in the banking giant. Citigroup is now in the process of breaking up its holdings, though the process could have been started months ago if taxpayer dollars had not been used to feed the zombie firm.

While the debate over when and if government should act as the "lender of last resort" remains unresolved, a clear principle should be that government money—tax dollars—should never be used to "prop up" failing firms. Firms that have neither re-organized nor changed their management have not yet reached their "last resort," despite uncomfortable conditions. As is clear from the Japanese example, these bailouts simply support inefficient business practices and perpetuate bad leadership.

Tax dollars—should never be used to "prop up" failing firms that have neither re-organized nor changed their management. Bailouts simply support inefficient business practices and perpetuate bad leadership.

B. Government developing conflicting interests

With all those loans, the Japanese government found itself too integrated into the market to have adequate incentives for sound policy. Daniel I. Okimoto, former director of the Shorenstein Asia-Pacific Research Center (APARC) at Stanford University, points out that the banking industry and the interests of Japan's economic bureaucracies, such as the Ministry of Finance, were too interdependent.[14]

Studies from the Bank of Japan and APARC concluded that data revealing the intense scope of the economic malaise was suppressed, and that regulations were developed with government interests in mind.[15] And at the height of government financial industry bailouts there was little transparency or public accountability.

The United States has ventured into these dangerous waters as well. In an attempt to recapitalize the banking industry, the Treasury Department forced the major banks to take bailout funds from the Troubled Asset Relief Program (TARP) in exchange for equity stakes in those banks. The federal government now owns a majority of the American International Group insurance company, as well as shares in General Motors and Chrysler.

The dangers of interconnectedness have already become apparent. Elected officials already feel emboldened to try to prescribe the compensation, travel and other business policies of companies participating in the program. In fact, the White House recently announced new regulations capping the salary of senior executives at financial institutions receiving federal bailout money at $500,000 a year.[16] Federal officials have criticized some specific spending decisions of participating firms, and more recently are demanding that banks that have received bailout funds increase their lending levels, regardless of whether or not such a policy is prudent, while they try to stabilize.

At the 2009 Detroit International Auto Show, GM unveiled more "green car" models than ever before. Was this in response to consumers or government? Recently, Citigroup changed a long-standing policy position on legislation favored by some leading Democrats. Did it change its lobbying position based on a legitimate reevaluation of the issue, or in response to its new "shareholders" in Congress?

The fact is that Congress lacks the expertise to run a bank or create viable business plans for any sector of the economy. Furthermore, lawmakers' incentives are to serve their constituencies or better their own personal political careers. This potentially puts them directly at odds with the businesses they are trying to manage. The more the government is involved in directing business activity, the less likely those firms will succeed in maintaining long-term growth.

Lawmakers have an incentive to serve their constituencies or better their own personal political careers, which potentially puts them directly at odds with the businesses they are trying to manage.

C. Short-term, static political vision and harmful monetary policy

The length of Japan's asset deflation, recession and liquidity struggles has been blamed largely on the lack of political leadership and willingness to choose the hard but necessary policies—such as letting banks fail and letting the market reset itself. Politicians bent on retaining their power and showing the public that they are "doing something" took action that sought to solve the present-day concerns without regard to their long-term effects.

There was little effort to clean up the banking system or get rid of harmful regulations. The government refused to acknowledge the breadth of Japan's economic troubles and the Ministry of Finance went so far as to order banks to hide their toxic loans to create the appearance of success. This was largely due to fear of the *keiretsus*, the powerful alliance of Japanese businesses that propped each other up with cross-shareholding and loans. Taking swift action would have upset the traditional way of business and forced the government to admit mistakes.

As previously mentioned, Japan reversed its tight monetary policies at the end of the 1980s in an attempt to solve the problem created by easy credit with easier access to money. Bad lending continued and the toxic debt Japanese firms held weighed them down. There was little political will to encourage banks to reorganize themselves in a healthier fashion, and continued government financial support perpetuated the banking malaise as well.

The political perspective was short-term and static, instead of long-term and dynamic. Politicians were fearful of upsetting the cultural norms and historical system. The principle of creative destruction—the process of economic mutation that continuously breaks down old forms and creates newer, more productive and efficient ones—was ignored in hopes that legacy corporations could save Japan, despite the proof of history that business needs to evolve for an economy to grow. As a result, no economic growth was ever sustained.

In the United States, the Federal Reserve has already begun a policy of quantitative easing—the process of lowering interest rates to increase access to credit. But maintaining artificially low interest rates in an attempt to spur economic activity and revive the economy will only perpetuate the distortions that already exist and make the inevitable correction longer and more severe.

A key problem is that American banks are still holding their bad debt, as Japanese firms did during the 1990s. This is partly due to low investor confidence keeping asset prices low and thus making it difficult for banks to sell their toxic debt. But it is also partly due to continued government intervention reducing the incentive for banks to make hard choices with regard to their balance sheets when bailout money is so easily obtained. The government is protecting banks from being punished by the market for their bad business decisions.

The government is protecting banks from being punished by the market for their bad business decisions.

Some economists have suggested that the government should buy toxic assets from banks and create a national bank to hold the bad debt. Others have suggested providing more capital to the banks to thaw their frozen balance sheets (already $330 billion TARP dollars have been spent along with special funds from the Fed for Bank of America and Citigroup). However, these policies run the risk of mirroring Japan's steps to prop up failing banks with federal loans.

Other policy changes, such as reducing the tax rate or eliminating the exclusivity clause in bankruptcy proceedings, would increase investor confidence and prompt private capital to flow back into the marketplace. Even the most toxic mortgage-backed securities aren't worthless. With renewed private investment, a market in these assets could emerge, allowing banks to sell off the debt and begin repairing their balance sheets.

Unfortunately, most of the policy proposals in the United States are focused only in the immediate term. The temporary nature of the jobs created by increased government spending (as explained below), the large debt and deficits that spending will create, and the increased taxes required to pay for the spending all will coalesce in the future to weaken the economy, eliminating any gains made in the short term. Japanese officials lacked the political will to do what would have been unpopular but better for their nation in the long term. The United States should reverse its easy money policies and stop providing funds and guarantees to failed businesses to avoid repeating the Japanese mistakes.

In an attempt to encourage growth, the Japanese embarked on a massive multi-billion yen infrastructure program building roads, bridges, and airports, all with the goal to create jobs and revive the economy. But it didn't work.

D. Tax policy errors

Japan tried to climb out of its economic mess by both cutting and raising taxes in different periods. There were two major tax cuts during the Lost Decade: a ¥5.8 trillion ($69 billion in today's dollars) income tax cut in 1994 that lasted for one year, and a ¥4 trillion ($46 billion) income tax cut in 1998 spread over two years.[17] The problem was that these tax cuts were not permanent and thus did not increase long-term aggregate consumption.

From 1994 to 1995, the Japanese economy began experiencing modest growth, partially due to the first tax cut. Deflation in 1995 reduced government revenues. In an effort to stem surging debt, the consumption tax was increased from 3 percent to 5 percent in 1997, which slowed the economy again. Daniel Okimoto cites a series of tax policy mistakes in his report on Japan's economic stagnation that includes the consumption tax hike and increased business taxes.[18]

There have been several proposed tax cuts and tax credits to stimulate the American economy. These include a $500 per taxpayer ($1,000 per family) tax credit that would eliminate all income taxes for up to 18 million Americans,[19] a two-year income tax moratorium, increased tax credits for education, reductions in capital gains taxes, and an increase in the amount of losses that businesses may write off on their taxes. While the decrease in taxes would be welcome, without a decrease in spending or borrowing it would require an increase in taxes later to cover the lost revenue and pay off the debt incurred.

Japan found that temporary tax-rate cuts combined with increased spending did not spur economic growth. Neither did an attempt to increase government revenues through tax increases benefit the economy. Decreasing taxes for businesses allows firms to keep more revenue, which in turn lets them reinvest that money to innovate and grow their business, hire new workers, pay out dividends, or just be inspired to continue their hard work. Tax cuts for individuals lets people have

more control over their income to pay down debt, save, invest or increase consumption. Those tax policies are the quickest way to stem a recession.

E. Government spending through infrastructure "investment"

In an attempt to encourage growth, the Japanese embarked on a massive multi-billion yen infrastructure program. They built roads, bridges, and airports, all with the goal to create jobs and revive the economy. But it didn't work.

During the 1990s, Japan passed 10 fiscal stimulus packages, focused largely on public works, totaling more than ¥120 trillion ($1.4 trillion in today's dollars).[20] When one construction plan did not work (meaning it did not cause the economy to return to rapid growth), another was tried. Those plans did not succeed in reviving the economy, but they did saddle the nation with a mountain of debt that helped to postpone any recovery for years. Including "off-budget" debts, Japan's debt was estimated to exceed 200 percent of GDP.[21]

Plans often set job growth targets, but rarely focused on project prices. From 1992 to 1999, the Japanese government spent over ¥45 trillion in public works projects.[22] Yet, construction jobs were not sustainable and did not lead to systemic economic growth. The public debt skyrocketed, unemployment actually doubled, and the economy remained stagnant. As Gavan McCormack, Pacific and Asian history professor at the Australian National University, noted in his book *The Emptiness of Japanese Affluence*, "The construction state is in some respects akin to the military-industrial complex in Cold War America (or the Soviet Union), sucking in the country's wealth, consuming it inefficiently, growing like a cancer and bequeathing both fiscal crisis and environmental devastation."[23]

Today, while some of the infrastructure projects Japan completed do serve society, their value should be compared to what the private sector could have created with the proper economic policies encouraging free market activity. The government failed to identify which projects should be pursued by ignoring demand signals only the private sector can recognize and respond to. For example, the numerous road projects, such as the New Tomei Expressway, do not serve a society that largely uses trains.

The United States has started down a similar path. Pres. Barack Obama and Congress are piecing together a stimulus package to spend around $50 billion on transportation infrastructure projects, and potentially another $500 billion on other public works projects. Naturally, the projects are being determined by members of Congress or state and local elected officials based on political interests rather than economic viability.

History shows, in Japan during the 1990s and in the United States through the New Deal programs of the 1930s, that a nation cannot spend its way out of a recession. During the Great Depression, President Roosevelt's massive spending program, which actually had its roots in the Hoover

administration, did not work to "stimulate" the economy. Despite all that spending and employment programs, unemployment remained extremely high. Prior to the stock market crash in 1929, the unemployment rate stood at a little over 3 percent. By 1933, in the midst of massive spending and public works projects, it had risen to 25 percent. Even after years of New Deal programs, unemployment remained around 15 percent or higher through 1940. It was not until World War II that unemployment dropped back to the low single digits.

Part 4

Conclusion

The Japanese government's policies of expanding the money supply, driving interest rates to artificially low levels, and poor regulation, coupled with risky behavior and ineptitude on the part of many firms in the financial sector led to distortions in private-sector investment that could not be sustained. These kinds of recessions are the unavoidable costs of years of an unsustainable boom fostered by government policy. While politicians would like to stave off the negative effects of the recession, such as the failure of businesses, bankruptcy, unemployment increases and a fall in housing prices, it should be clear that liquidations and corrections are necessary in order to realign consumer preferences and the structure of production.[24]

The Japanese government was not willing to make the hard but necessary choice to let businesses fail and let the market correct itself. Instead, it lent trillions of yen to *keiretsus* businesses (taking that cash away from more productive ventures), passed counteractive tax laws and regulations that did not promote growth, manipulated the credit markets with poor monetary policy and spent trillions of yen on infrastructure projects that only increased unemployment and left the nation with massive debts.

This short-term, static view attempted to prevent the economy from experiencing any negative effects from the correction, but it only prevented Japan from rolling out of its asset bubble downturn and made the crisis worse.

By repeating many of the same mistakes that created Japan's Lost Decade, the U.S. government is making the recession worse and last longer than it should.

The United States government is repeating many of the same mistakes that created Japan's Lost Decade, becoming entangled with the business community through bailout equity buys and trillions of dollars in loans to keep failing American firms alive. This policy is making the recession worse, extending it longer than it would otherwise last.

Any attempts to artificially spur credit expansion through either low interest rates or "fiscal stimulus," will only add to economic distortions and make the market correction longer and more severe. Spending hundreds of billions of dollars on infrastructure, broadband Internet and healthcare may provide some short-term benefits for some Americans, but, as Japan discovered the hard way, it won't rescue the economy.

The history lessons from Japan are plentiful and clear. It simply remains for decision makers to pay attention. There is still time, but if the government continues its pattern of coercion and intervention much longer, the United States will transition to a zombie business economy.

About the Authors

Anthony Randazzo is a policy analyst at Reason Foundation. He specializes in finance, economic policy, government reform and privatization policy, and is associate editor of the newsletter *Privatization Watch*. Mr. Randazzo's work has been featured in *The Detroit News*, *Chicago Sun-Times, Hawaii Reporter* and various online publications. Randazzo graduated from The King's College, New York City with a Bachelor of Arts in politics, philosophy and economics.

Michael Flynn is director of Government Affairs for Reason Foundation. Mr. Flynn has more than 15 years experience in the development, implementation and analysis of public policy. His work has been cited by *The Wall Street Journal*, *Washington Post*, *New York Pos*, and numerous regional newspapers and radio. Mr. Flynn is a graduate of the University of Iowa, where he studied English and Economics.

Adam B. Summers is a policy analyst at Reason Foundation. He has written extensively on privatization, government reform, law and economics, public pension reform, occupational licensing, and various other political and economic topics. Mr. Summers's articles have been published by the *Los Angeles Times*, *San Francisco Chronicle*, *San Diego Union-Tribune*, *Orange County Register*, *Los Angeles Daily News*, *Baltimore Sun*, *Los Angeles Business Journal* and many others. Summers holds an M.A. in Economics from George Mason University and earned his Bachelor of Arts degree in Economics and Political Science from the University of California, Los Angeles.

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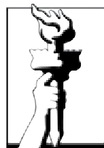

Reason Foundation
3415 S. Sepulveda Blvd., Suite 400
Los Angeles, CA 90034
310/391-2245
310/391-4395 (fax)
www.reason.org