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Avoiding America's Lost Decades

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The warning bells were sounded in early 2009: The U.S. government had to act swiftly and forcefully to avoid repeating Japan's painful experience of sustained economic stagnation.[1] The Obama Administration's policies have failed to this point, and Japanese-style long-term stagnation may well ensue unless a fundamental course correction and decisive steps are taken. The two most important steps are to halt the federal government's regulatory onslaught and to put the federal budget on a credible path toward balance by cutting spending quickly and steadily.

Japan's Fall. It is hard to exaggerate the shift in Japan's fortunes over the past two decades. The Japanese economic miracle lasted over 40 years and saw the country climb out of true devastation from World War II to have the globe's second-largest economy, as measured by gross domestic product (GDP). Many observers thought it was only a matter of time before Japan replaced the United States as the world's leading economy.

How times have changed. The conventional wisdom now is that Japan suffered a "lost decade." Actually, it has been almost two decades, and there is no end in sight to the stagnation. In 2010, the Japanese economy looks to have been smaller than it was in 1992, an incredibly poor result. It is not just a matter of a decline in output; it is also a remarkable decline in total wealth. In 1991, excluding micro-states like Luxembourg, Japan was the fourth-richest country in the world as measured by GDP per capita. In 2010, it was no longer in the top 20, was below the OECD average, and would have likely fell further but for Europe's own economic troubles.[2]

The American and Japanese situations are certainly not identical. But there is no reason to think that the U.S. is magically immune from this scenario if it mimics Japan's mistakes. America's economic demise is by no means certain, but neither is its continued prosperity or its leading role in global affairs.

In 2030, if current trends continue, it could be that the U.S. will have been passed by China in economic size. Worse, if the U.S. repeats Japan's mistakes, then America may be at risk of being rendered an afterthought on the world stage, much as Japan is now. At home, a decline in comparative American wealth equivalent to Japan's would take the average American from over 30 percent richer than the average Spaniard in 2010 to no richer in 2030—equivalent to a $14,000 drop.

Why It Happened. What are (or were) Japan's mistakes? One could point to the Japanese government's decision to prop up "zombie banks" after the asset bubble popped in 1990, a decision that greatly impeded the healing of the financial sector and thus the economy.

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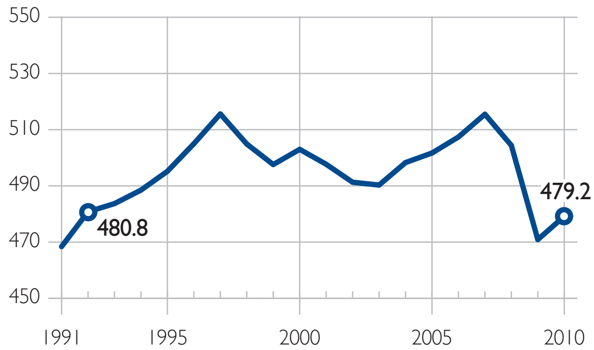
Japan's Economy Smaller in 2010 Than in 1992

Japan's Nominal GDP, in Trillions of Yen, Current Prices



Source: Organisation for Economic Co-operation and Development, Statistics Portal, at *http://www.oecd.org/statsportal/0,3352,en_2825_293564_1_1_1_1_1,00.html* (October 6, 2011).

Chart 1 • WM 3398 heritage.org

However, the most glaring of Japan's mistakes has been its fiscal policy. Japan is arguably the world's most indebted major economy, with public debt close to twice the level of GDP. This is a problem created during the lost decades, not before. Nominal debt soared 170 percent from June 1996 to June 2010 even while GDP declined slightly.[3] Japanese fiscal stimulus has been an utter failure.

The first few attempts at Keynesian stimulus may have been understandable. What extended Japan's misery was the inability to accept that deficit spending does not stimulate the economy. Every few years, a new twist was added. Each time, the new economic elixir was advertised to remedy Japan's ailments, and each time more debt built up and more money was wasted.

Even now, deficit spending is considered by some to be necessary if only it is done right this time. Meanwhile, the hard work of shrinking deficits and debt is being conveniently put off until later because economic growth is supposedly too weak now to survive the loss of fiscal stimulus.[4]

Japan cannot anticipate renewed economic growth from either a growing labor force or from more use of land (either agriculture or natural resources). The size of the labor force is declining, and there is little in the way of natural resources waiting to be drawn into production. Thus, Japan must rely on innovation and more efficient use of productive capital.

An oversized government inhibits broad, long-term innovation—for example, through regulatory barriers that kill the incentive to innovate. Japan's debt is almost entirely domestically financed, which means gigantic sums are shifted from the private sector to the public sector, where the social return on investment is almost nil and the yields paid on the debt are only slightly better. The huge debt and oversized government has sapped Japan's domestic sources of growth.

It is therefore not surprising that Japan has been desperate for foreign sources of growth. The periods of seeming mild recovery that have occurred in the past 20 years have all been driven by foreign demand. Japanese financial policy has been warped by the attempt to extract growth from others (for example, through exchange rate intervention).

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/reports/2009/02/two-lost-decades-why-japans-economy-is-still-stumbling-and-how-the-us-can-stay-upright.*
2. Organisation for Economic Co-operation and Development, Statistics Portal, at *http://www.oecd.org/statsportal/0,3352,en_2825_293564_1_1_1_1_1,00.html* (October 14, 2011).
3. Japanese Ministry of Finance, "Central Government Debt," at *http://www.mof.go.jp/english/jgbs/reference/gbb/index.htm* (October 14, 2011).
4. Adam S. Posen, "The Realities and Relevance of Japan's Great Recession Neither *Ran* Nor *Rashomon*," lecture at the London School of Economics, London, May 24, 2010, at *http://www.bankofengland.co.uk/publications/speeches/2010/speech434.pdf* (October 14, 2011).

But the more serious financial failing is the loss of the Bank of Japan's credibility.[5] Rather than quietly holding to a consistent policy, the central bank has announced so many different strategies for stimulus that its initiatives are now immediately dismissed.

Lessons for the United States. The Congressional Budget Office estimates that the federal budget deficit in 2011 was $1.3 trillion, matching the 2010 deficit and down just slightly from the all-time record of $1.4 trillion in 2009.[6] Under President Obama, the federal government has run deficits in three years totaling twice what occurred under President George W. Bush in eight years. The pattern of U.S. government deficits has taken a decidedly Japanese appearance.

Part of the explanation for these deficits is the recession itself, which cut deeply into tax receipts and increased government spending through automatic programs such as food stamps and unemployment insurance benefits.[7] But repeated bouts of Keynesian-style stimulus have also contributed substantially, beginning with President Obama's huge stimulus legislation in 2009. As is now abundantly clear, this approach to recession and recovery has failed as miserably in the U.S. as it did in Japan.

There are other notable similarities between the Japanese experience and American policy. For example, the Japanese government has repeatedly raised taxes and is considering doing so again. In the U.S., President Obama repeatedly urges higher individual income tax rates on savers, investors, and small businesses, as though taxing producers will somehow increase production.

The Japanese economy is rigidly structured, inhibiting its ability to adjust to changing conditions. In the U.S., President Obama is advancing a wave of regulatory changes that are inhibiting flexibility and dampening the recovery. From inauguration day until March 2011, regulatory agencies imposed 75 major new regulations (defined as those costing $100 million or more), imposing some $38 billion in new costs annually.[8]

Those are just the regulations through the bureaucratic pipeline. They do not include the ongoing regulatory freeze on economic activity from the passage of President Obama's health care legislation or the Dodd–Frank regulatory wave falling on financial services.

Do Less Harm. Though much damage has already been done, the American economy is still fundamentally flexible and resilient. What is needed is to jettison the convenient fantasy that deficit spending stimulates the economy and instead adopt a more benign attitude that, for the sake of recovery, Washington should "first, do less harm," which means:

- The federal government should rein in spending to restore a degree of confidence in America's future,
- The President should stop threatening higher taxes, and
- The Administration should end the regulatory attack on America's businesses.

The U.S. is still well-positioned to turn its economy around and avoid Japan's fate. If Washington

5. Japanese Ministry of Internal Affairs and Communications, Director-General for Policy Planning and the Statistical Research and Training Institute, "Foreign Trade, Balance of Payments and International Cooperation," 2008, at *http://www.stat.go.jp/english/data/chouki/18.htm* (October 14, 2011); Toru Fujioka and Aki Ito, "Bank of Japan Debates Policy Limits as Shirakawa Warns of Credibility Risk," Bloomberg, May 26, 2010, at *http://www.bloomberg.com/news/2010-05-25/boj-should-avoid-resource-allocation-with-new-lending-some-members-said.html* (October 14, 2011).
6. See Congressional Budget Office, "Monthly Budget Review," October 2011, at *http://www.cbo.gov/doc.cfm?index=12461* (October 14, 2011).
7. Douglas Elmendorf, Director, Congressional Budget Office, letter to Congressman Chris van Hollen (D–MD), October 4, 2011, at *http://www.cbo.gov/ftpdocs/124xx/doc12440/10-04-Portion_of_Deficit_Due_to_Cyclical_Weakness.pdf* (October 14, 2011).
8. James L. Gattuso, "Taking the REINS on Regulation," Heritage Foundation *WebMemo* No. 3394, October 12, 2011, at *http://www.heritage.org/Research/Reports/2011/10/Taking-the-REINS-on-Regulation*.

would just do less harm—and if the Japanese government would just do less harm in Japan—each country would enjoy a more prosperous future.

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