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U.S. Hears Echo of Japan’s Woes

By MARTIN FACKLER and STEVE LOHR

TOKYO — In the annals of economic policy blunders, the one in which Hiroshi Kato played a hand in early 1997 ranks among the biggest in recent Japanese history.

Mr. Kato led a government advisory committee that concluded that the economy, which was then finally starting to rebound from the collapse of its 1980s land and stock bubbles, was healthy enough to raise the national consumption tax to 5 percent from 3 percent.

Aimed at reducing deficits, the tax increase instead quickly snuffed out the fragile recovery, pushing Japan to the brink of a financial meltdown and thrusting the nation deeper into the economic morass from which it has yet to emerge even today.

“Our sins are large,” Mr. Kato, now president of Kaetsu University in Tokyo, said ruefully. “I hope the rest of the world can learn from this mistake.”

And indeed, the lessons of Japan’s long stagnation are well known to American policy makers like the treasury secretary, Timothy F. Geithner, and the chairman of the Federal Reserve, Ben S. Bernanke, who have studied Japan’s policy missteps.

In 1999, Mr. Bernanke, then an academic, tartly criticized Japanese officials for mishandling their

1990s financial crisis, saying Japan's plight was "self induced." Partly because of that expertise, American policy makers have long been confident, even during the darkest days of the current financial crisis, that the United States could avoid the fate of Japan and its two lost decades.

But now, with growing signs that the United States might be a lot closer to a Japan-style slump than previously thought, that confidence is waning.

In the United States, a robust recovery remains stubbornly elusive, and Mr. Bernanke is said to be ready to take new, unconventional steps to increase the money supply in order to maintain the uncertain growth of the past year. He is also said by close associates to favor further fiscal measures to stimulate the economy. But in the current political climate, with Republicans poised to make strong gains in the midterm elections while preaching fiscal austerity, the prospect of more federal stimulus spending seems remote, and it is unclear if monetary policy alone will be enough to restore healthy growth.

Partly as a result, some economists now predict that it could take years or even a decade for the American economy to regain the levels of employment and vigor achieved before the 2008 crisis. The growing political pressure for cuts in federal spending — along with plunging consumer confidence and companies that seem more intent on cutting costs and hoarding cash than investing in new growth — have led economists to talk of the United States' entering a grim new era of austerity.

That is very close to what befell Japan two decades ago, when the seemingly invincible Asian economic juggernaut fell into a deep rut of chronically anemic demand and corrosive price declines, known as deflation, from which it has never fully recovered. The parallels are so striking, and unsettling, that economists are now taking a renewed look at Japan for insights on how the United States can avoid the deflation trap.

"There has been a political and intellectual arrogance in the United States that it won't happen to us," said Adam S. Posen, a senior fellow at the Peterson Institute for International Economics in Washington. "We shouldn't be so smug. You can get there without being Japan."

Indeed, the financial crisis that crippled Japan’s once high-flying economy appears an eerie precursor of the one that struck much of the global economy in 2008. In Japan, a huge expansion in credit created twin price bubbles in the land and stock markets that, when they burst in the late 1980s and early 1990s, left banks and other companies drowning in failed real estate investments.

But perhaps the most alarming part is what came next: a collapse in demand that pushed prices and ultimately wages into a self-reinforcing deflationary spiral, which made already stingy individuals and businesses even less willing to use money, because falling prices meant that cash itself gained in value.

Japan has remained trapped in this spiral despite the equivalent of trillions of dollars in stimulus spending, more than a decade of near-zero interest rates and even unconventional steps by the central bank similar to those now contemplated by Mr. Bernanke, like purchasing corporate and government bonds to increase the money supply.

Despite the strong parallels, there are still reasons to think the United States can escape what has been called Japanification.

The United States and Japan are very different, culturally and politically, and Japan faces a host of unique problems that have sapped its vitality, like a rapidly aging populace that has created generational tensions, and the closing of its doors to immigration and the youthful labor and fresh ideas that can bring. Economists say the dynamic United States economy has shaken off seemingly intractable slumps before, as in the frightening recession of 1980-82, when conditions and the prospects for recovery seemed, for a while, every bit as bleak as they do now.

However, some warn that the United States could still get it wrong, especially if the midterm elections produced a sharply divided political landscape.

“The danger is if the U.S. plunges into policy paralysis just like Japan in the 1990s,” said Shumpei Takemori, an economist at Keio University in Tokyo. “Ideological divides and political divides can make bold policy action impossible."

In fact, some economists warn that the United States may be deeper into Japan-style stagnation than is widely realized. Simon Johnson, a former chief economist at the International Monetary Fund, estimates that the total output of the American economy this year will be no higher by his estimate than it was in 2006.

"We've already lost half a decade," said Mr. Johnson, now a professor at the Massachusetts Institute of Technology.

In addition, economists say, Japan had one advantage the United States does not. With its high savings rate, the government could borrow from its own domestic sources at minuscule rates to finance trillions of dollars in stimulus projects. By contrast, the United States has to sell its government bonds to foreign investors, who are likely to demand higher interest rates as its national debt grows.

Leading Japanese economists also said their nation's many failures — like the 1997 tax increase — yielded one crucial lesson on combating the aftereffects of a financial panic: the need to avoid policy flip-flops.

"The lesson is that there is a proper sequence for pulling a nation out of a financial crisis," said Heizo Takenaka, an economist who was the architect of the successful cleanup of Japan's banking system in the early 2000s. "First, you restore growth before worrying about deficits."

However, Mr. Takenaka acknowledged that while the banking problems have been largely fixed, Japan has yet to come up with a strategy for restoring growth, which he says is the only way to end deflation.

This month, Japan's central bank pushed its benchmark rate back down to zero. However, central bankers here argue that it is not enough just to loosen monetary policy when a lack of borrowers and new investment means there is no demand for money to start with. And this points to another feature of Japan's experience that may already be visible in the United States: the paradox of a stagnant economy that is awash in cash.

This occurs when companies and individuals stop spending and banks stop lending for fear that anemic growth and rising bankruptcies will result in defaults. This is particularly apparent in regional economies outside Tokyo, which remains relatively vibrant.

In a healthy economy, banks typically lend out more money than they have on deposit. But in Osaka, Japan’s third largest city and commercial hub, nearly two decades of hoarding of cash created the unusual situation in 2002 of deposits at all the city’s banks surpassing their outstanding volume of loans. Since 1997, the total amount of loans by the city’s banks has fallen by a third, to $530 billion, while deposits have risen by 20 percent, to $767 billion.

“Deflation has made everyone very conservative and eager to hold cash,” said Hiroshi Tanaka, a senior director at Osaka Shinkin Bank. “We have too much cash and nowhere to invest it all.”

This has created distortions in Japan’s economy. One is a sharp drop in the number of times cash changes hands in normal business and spending transactions. This so-called velocity of money has dropped to about a third the level of the United States, according to figures from the Mizuho Research Institute in Tokyo.

Another distortion is Japan’s so-called dresser savings — the piles of cash that individuals keep at home for fear that their banks may also go bankrupt. These stashes are estimated to total about $370 billion, according to Akira Otani, a researcher at the Bank of Japan.

Economists see early signs that the United States is heading down the same path. Recent data shows a surge in savings rates to 6.4 percent in June from less than 1 percent in 2005, reflecting consumers’ reluctance to spend, and continued disinflation.

The picture is not entirely bleak for the United States, where the constant drive to innovate can produce bursts of growth that few economists or anyone else can see coming. While Japan was seen once as an unstoppable powerhouse, the picture was altered by wave after wave of technological innovation in the United States — the personal computer industry, then the Internet and Web businesses, smart phones, and mobile software. That dynamism, economists note, is often wrenching. But it also means that investment dollars and people shift more rapidly to new opportunities. In Japan, though, such painful payroll cuts and corporate deaths were postponed for years.

The American approach to economic adjustment is "shock treatment," said Edward J. Lincoln, director of the Center for Japan-U.S. Business and Economic Studies at New York University, while "Japan favors stability and the corporate socialization of the pain."

"Deep down inside, as an American," Mr. Lincoln said, "I tend to think that the United States' approach makes for a healthier economy in the long run."

Martin Fackler reported from Tokyo, and Steve Lohr from New York.

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