Advice from Japan: Spend your way to prosperity

By Marcus Gee
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Richard Koo has a message for G20 leaders gathered in Washington to deal with the global financial crisis: spend, spend big, spend till it hurts and when you are tired of spending, spend some more.

Mr. Koo has devoted much of his career to studying how Japan coped with its own financial crisis in the 1990s. He says the lesson is clear.

"Japan has proved to the world that you can use fiscal policy to keep GDP from falling," Mr. Koo, chief economist for Japan's Nomura Research Institute, said in an interview at his Tokyo office. "And that lesson is a big one for mankind."

For years, Mr. Koo was a voice in the wilderness, taking the unpopular line that Japan's much-criticized solution to its decade-long downturn — massive public spending — actually worked. Now, with the world experiencing a financial debacle much like Japan suffered, his views are getting a closer look.

With the heat of a crusader, he argues that merely bailing out banks and cutting interest rates to stimulate the economy isn't enough in a full-scale collapse like the current one. What is needed is a flood of government spending.

That's because, as he explains in his new book, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*, the world is suffering from a rare and deadly disease, the same one that Japan suffered in the nineties: a "balance-sheet recession."

In such a downturn, companies focus single-mindedly on reducing debt, and this acts as a barrier to the normal flow of money through the economy. No one borrows because everyone is desperately paying down debt.

Spending can halt the cycle. Japan spent hundreds of billions of dollars to shore up the economy during its "lost decade."

To many in the outside world, it looked like a gigantic waste. Japan's economy remained more or less flat on its back for a dozen years. Real estate values dropped a staggering 87 per cent. Stock prices never climbed back to their pre-bust levels. With all that stimulative spending, Japan accumulated a crushing national debt, today the biggest proportionally in the industrialized world.

Is Mr. Koo really suggesting that the United States and other crisis-hit countries should repeat Japan's ruinous experience? He insists that they have no choice. If Japan's government had not opened its wallet the way it did, "Japan would probably have disappeared from the economic map of this world."

Instead, it kept its GDP higher than pre-crisis levels throughout its fight to get the economy moving again. Mass unemployment was avoided. It was a dismal decade, but it could have been worse.

Mr. Koo recently travelled to Washington to brief Bush administration officials and give a talk at a Washington think tank, and he has also spoken to Chinese officials about his balance-sheet recession theory.

What he tells them is that when asset prices collapse, as they did in Japan and as they have in the United States with the housing and now stock-market meltdowns, companies suddenly find themselves "underwater," with liabilities far outweighing assets. Quite naturally, they desperately start paying down debt — and stop borrowing.

That's a problem because in a normal economy, banks and other financial institutions channel household savings to corporate borrowers, who use it to invest and grow. When no one is borrowing — in Japan, despite interest rates that reached near zero for years — this mechanism stops working. The problem was especially acute in Japan because the plunge in assets was so steep. The loss of wealth equalled three years of national output, Mr. Koo says.

A similar halt to borrowing may occur in the United States, he says, because households, like Japanese corporations back then, are underwater and many may start frantically paying down debt.

In Japan, he writes in his book, "disastrous consequences were avoided only because the government took the opposite course of action. By administering the fiscal stimulus, which was also the right thing to do, the government succeeded in preventing a catastrophic decline in the nation's standard of living despite the economic crisis. In this sense, it could be argued that Japan's fiscal stimulus was one of the most successful economic policies in human history."

To nourish an economy starved of borrowing, governments must turn on the fiscal tap. "The sooner the better," says Mr. Koo, Taiwanese by background, who was once an economist with the Federal Reserve Bank of New York and often advises the Japanese government. "If you have infrastructure to fix, if you need to spend on your health-care system, do it now."

He says that as soon as he takes office, U.S. president-elect Barack Obama should tell the American people they are in an unusual crisis — balance-sheet recessions happen only once every few decades — and announce a massive fiscal stimulus package.

It doesn't matter much where he directs the money. "Fix the freeway system in the Los Angeles area. There is no dearth of projects you can spend money on," he says.

The point is to keep the money flowing and not to let up. Japan let up twice during its downturn, after becoming alarmed at its rising debt and trying to cut the budget deficit. The result, Mr. Koo says, was to set back the recovery while actually hurting the country's fiscal position when a slower economy cut into tax revenues.

Mr. Koo also argues that governments should focus on spending rather than tax cuts, because in a downturn such as this, households may simply take their tax cut money and apply it to debt, worsening the balance-sheet recession problem.

Mr. Koo admits not everyone buys his theory. When he pushed it in the thick of Japan's downturn, "everyone was against me. Now the number has shrunk to a very few."

He has tangled with Paul Krugman, the Nobel Prize-winning economist who argued Japan could fix its problem by deliberately spurring inflation. He also disagreed with Ben Bernanke, now head of the U.S. Federal Reserve.

Now, he says, events have vindicated his theory and everyone is coming around to the idea of fiscal stimulus, including old foes such as Mr. Krugman. Indeed, Mr. Krugman wrote in The New York Times yesterday that the federal government should put together a stimulus package of about $600-billion. Better, he says, "to err on the side of doing too much than on the side of doing too little."

Many Republicans are resisting the idea. So are many conservative economists. In The Wall Street Journal yesterday, Heritage Foundation fellow Brian Riedl argued that the money that governments put into the economy through stimulus packages "must first be taxed or borrowed out of the economy," leaving it no further ahead.

Mr. Koo admits that what he is proposing is costly. "Once you have a bubble and it eventually bursts, the repair cost is just enormous."

On the other hand, he says, Britain's debt at the end of the Second World War was 250 per cent of GDP, far higher than that of Japan, which today has a gross public debt of 180 per cent of GDP.

"The U.K. did not fall off the map," he says. "If Mr. Churchill said in 42-43: 'Government is too large, let's cut the production of Lancasters and Spitfires,' then the U.K. would have disappeared and we would have Hitler's Third Reich, right?"

The lesson, he says, is that as costly as it may be to spend your way out of this sort of crisis, the cost of not spending is far higher.