Richard Koo: Lessons from Japan's Decline

By Dan Richards
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A video of this interview is available here.

Richard Koo is the Chief Economist of Nomura Research Institute, the research arm of Nomura Securities, Tokyo. Before joining Nomura in 1984, Mr. Koo, a US citizen, was an economist with the Federal Reserve Bank of New York (1981-84). Prior to that, he was a Doctoral Fellow of the Board of Governors of the Federal Reserve System (1979-81). In addition to conducting financial market research, he has been appointed by several different Japanese prime ministers to a number of key committee positions to study the future of the Japanese economy. He has been named the top analyst of the Japanese economy and has spearheaded the national debate in Japan on how best to save the country's ailing banking system.

Dan Richards interviewed Koo at the CFA conference in Boston in May.

Let's start by talking about some of the lessons from the problems that Japan had in the last 20 years. Can you quickly summarize the two or three conditions that led to Japan's economic woes starting roughly in 1989?

We didn't realize that we had contracted a different disease. We thought it was the typical cyclical downturn where we fell into recession, but it was a very different type of disease altogether. The disease was caused by a massive nationwide asset price bubble that was financed with debt.

Real estate in particular?

Real estate, the stock market, and everything else. When that bubble collapsed, asset prices fell, but the liabilities remained. Balance sheets all over Japan in the private sector were underwater. Although they were bankrupt, the cash flow of many of these companies was still very good. Japan continued to run one of the largest trade surpluses in the world. So companies had the cash flow, but balance sheets were underwater.

If you put anyone in that situation, what would they do? They will use the cash flow to pay down debt, because shareholders don't want to be told that their shares were just a piece of paper. Bankers don't want to be told that their loans are all nonperforming. Workers don't want to be told that there are no more jobs tomorrow. For all the stakeholders involved, the right thing to do was to use the cash flow to repair their balance sheets.

The problem is, when everybody does that all at the same time, what happens to the national economy? If someone is saving money or paying down debt, you better have someone on the other side borrowing and spending money. In the usual world, we have the financial sector in the middle taking the money from this side and giving it to people on that side. If there are too many people who want to borrow money, interest rates rise; if there are too few, you bring interest rates down, and the money circulates in the economy.

But what we discovered when our bubble burst was that even with zero interest rates, no one was borrowing money. Everybody was paying down debt, because their balance sheets were all underwater. No one wanted to borrow money.

From a public policy perspective, what can governments do when faced with this kind of situation?

That's the key issue now going forward. We learned that once we fall into this type of recession, where everybody is paying down debt and no one is borrowing money, monetary policy is the first casualty, because people with balance sheets that are under water are not interested in borrowing money at any interest rate. They have to repair their balance sheets as quickly as possible. So you bring interest rates down to zero, and nothing happens.

In Japan, we had rates almost zero starting in 1995, and the recession lasted until 2005; for 10 years nothing happened. I see the same thing happening here in the US, in the UK, and in other parts of the world. Rates are the lowest in history, and still there is very little response from the private sector.

So, monetary policy is not a solution. How about fiscal policy?

Fiscal policy is the solution. The government cannot tell the private sector, “please don't repair your balance sheets,” because the private sector has no choice. They have to repair their balance sheets. But if the private sector continues to save and other parts of the private sector are not borrowing, government has to borrow that money and spend it in order to keep the GDP from falling.

Let me give you an American example. If I have $1,000 on income, and I spend $900, and I decide to save $100, the $900 is already someone else's income. So this is not a problem. But under usual circumstances, someone will take the $100 that we saved, spend it, and then $900 plus $100 is $1,000 against the original income of $1,000, and the economy will swallow it.

In a balance sheet recession, the $100 gets stuck in the financial system. It cannot go out, because borrowers are trying to repair their balance sheets. If you do nothing about the situation, the economy is down to $900. If the $900 is someone's income, and that person decides to save 10% (and has $810 to spend), then $90 is going to the financial sector. But this $90 gets stuck, because people are still repairing their balance sheets.

If you do nothing about the situation, the economy will go from $1,000 to $900 to $810 to $730 very, very quickly. The last time anything like this actually happened was the Great Depression in the United States from 1929 to 1933, when the US lost half of its GDP in just four years, through the process I just described.

The only way to keep this process from happening is for the government to borrow the $100 and put that back into the income stream, then it is $900 plus $100 again, and there is no reason for GDP to fall.

Japan faced this problem throughout the 15-year period [that began in 1989]. The net debt repayment by companies was over 6% of GDP and household savings were 4% of GDP. We could have lost 10% of GDP every year, but we managed to keep our GDP from falling below its value at the peak of the bubble for the entire 20-year period, because government was borrowing and spending that money. So, fiscal policy is the key.

Is the US suffering from a lack of demand?

Exactly, demand collapses. In this case, and in this case only, the government has to step in and borrow the excess savings in the private sector, and put that back into the income stream.

Until the private sector deleveraging is over, those actions have to be in place for the whole period. We already have had a fiscal stimulus in United States – a $787 billion package enacted in February of last year.

We learned in Japan that this stimulus has to remain in place until this process is over. The mistake we made in Japan was that once the economy began to improve, we said, "The budget deficit is still large." We cut the stimulus, and the economy weakened again. We put in another stimulus, and the economy improved. Then we said, "The budget deficit is too large." We cut it. It went down. That's why it took us 15 years.

How long should the US and other economies – such as England or other European countries – continue with their stimulus efforts?

Given that the bubble itself wasn't as bad as the one in Japan, and the US and UK have the Japanese example to look at, they will recognize that this is not the same disease as a garden-variety recession. If everything is done correctly, it might take maybe five years.

But if the US makes the same mistakes we made in Japan, such as in 1997 when we tried to cut the budget deficit prematurely, then the whole thing can go on much, much longer.

The prescription that you're putting forward is for potentially five years of deficit spending by governments to maintain demand. How do you respond to someone who says well, that's what Greece has been doing, and look at the mess that they are in? There is a flight from Greek bonds because the markets are very nervous. How do you address those concerns?

The Greek problem is a totally different one, because they were increasing their budget deficit without what I call a balance sheet recession happening. They were spending like crazy for no good reason whatsoever. I don't think we should compare Greece with what's happening in the US or the UK, even though the budget deficit numbers may look similar.

In the US and UK there is definite evidence that the private sector is deleveraging. That occurring with zero interest rates is very unusual. In those economies, and those economies only, we have to rely on fiscal stimulus.

Ken Rogoff has written a book about the perils of increased sovereign debt levels. What is your take on his work, and particularly for Japan in terms of how it's going to deal with its debt level currently?

People have the right to worry about debt levels, but if a balance sheet recession is the reason why the economy is so weak, then the government has to take the extra savings generated in the private sector and put it back into the income stream. If government decided to stop playing that role by saying, "Our budget deficit is too lousy, but we can't charge it to our grandson's credit card," then the economy will collapse and debt levels will actually increase.

On two occasions the Japanese government listened to the IMF, which didn't know much about what was happening in Japan, and told us to cut our budget deficit. In 1997, the IMF argued that all the fiscal spending was not bringing much growth. Prime Minister Hashimoto listened to those guys and we raised taxes, cut spending, and guess what? The economy collapsed.

First, our budget deficit skyrocketed. It took us years to bring the deficit back down to where it was before 1997. When the private sector is deleveraging, which is the case in the US, UK, and Spain at this very moment, the option of cutting a budget deficit might not exist at all. Unless the private sector is willing to take the extra savings that government is not borrowing through increasing taxes or whatever, and unless the private sector comes in and snaps up whatever money the government is not borrowing and puts it back into the income stream, the economy will collapse.

Are there options other than the government spending (and raising deficits), for example tax incentives for companies to invest?

A tax cut is a fiscal stimulus, right? A fiscal stimulus is needed. Of course, some tax cuts may be useful, but if a general income tax cut comes when the private sector is deleveraging, the private sector will take that and use it to pay down debt. It is still better than nothing, but for the same budget deficit you are incurring, a tax cut will give you much less fiscal stimulus to the economy, because so much of that will leak out in repayment [as companies use those tax savings to improve balance sheets].

What about a targeted tax cut, perhaps based on incentives to invest and spend in the private sector, instead of a broad tax cut?

Even targeted ones might not be as effective. If corporate executives realize that the private sector is also deleveraging, they will question the point of adding additional capacity when the economy will be shrinking going forward. In a circumstance like that, fiscal stimulus, government borrowing, and actually spending money is far more effective in terms of keeping the economy going than tax cuts.