



Our Analysis: Is the US headed for a Lost Decade?

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Read a summary of the Reinhart and Rogoff paper in the accompanying [article](#) in today's issue.

The Reinhart and Rogoff paper has received considerable attention in the media and in academic circles. The implication that the US could be headed for a lost decade, similar to what Japan experienced in the 1990s, is largely responsible for this heightened focus. The Japanese equity markets declined by 60% between 1990 and 1992, while housing prices declined steadily and by a greater amount until 2000. A repeat of a lost decade is certainly a worst case scenario, and understanding the probability of such an occurrence is an important exercise.

For our analysis, we look at the economic conditions in Japan in the 1990s and those in the US today, in order to identify significant similarities and differences:

- Japan went through a deflationary period in the 1990s, with a decline in nominal prices. Consumers and businesses restrained their spending, with the hope or expectation that prices would continue to decline. By contrast, inflation in the US is around 4%, and some fear it could go higher with interest rate cuts and the continued weakening of the dollar.
- The dollar/yen exchange rate was relatively stable during the 1990s. By contrast, from 1970 to 1990 when Japan experienced exceptional growth, the value of the yen declined significantly versus the dollar, aiding Japan's export industries. For the past several years, the value of the dollar against our major trading partners has also been declining.
- The Japanese economy is characterized by permanent employment for some employees of large corporations and close government-business relationships. Neither of these factors plays a significant role in the US economy. In Japan, permanent employment prevented businesses from downscaling to achieve profitability, and close government-business relationships contributed to slow and ineffective government responses to the crisis.
- The Keiretsu system was prevalent in Japan through the 1990s. This refers to close relationships among businesses, usually built around banking relationships. Japanese banks were slow to recognize and write off non-performing loans, especially with respect to firms in their Keiretsu.



This was particularly true for small and mid-sized business loans, which represented almost half the loans made to Japanese businesses during this period. Most economists cite this practice as prolonging Japan's crisis.

- Japan's government responded to the crisis through fiscal policies geared to spending on public infrastructure, which economists argue have a low "multiplier" (e.g., money spent on building roads and bridges has proportionately less impact on stimulating growth in other parts of the economy). So far, the US response through fiscal policy has been the recently passed tax rebate, with the rationale that it will have a high multiplier.
- For much of the lost decade, Japanese interest rates hovered near zero, in what was termed a liquidity trap. Monetary policy could not stimulate the economy, and investors preferred to hold their money rather than buy low yielding securities. By contrast, the discount rate in the US is now at 3.5%, approximately 200 basis points higher than it was at the nadir of the last recession, in 2001. The US has the flexibility to utilize monetary policy, if it chooses.
- Japan's mortgage and securities markets had not undergone securitization, as have the US markets. Japanese banks held the mortgage debt. In the US, risk has been spread across a range of financial institutions and investors, many of whom are not domiciled in the US.
- There are notable demographic differences. Japan had a higher percentage of the elderly (measured as the "elderly dependency ratio"). Japan and the US had approximately the same elderly dependency ratio in 1992, but since then Japan's has risen steadily while the ratio in the US has remained stable. Japan had a lower child dependency ratio than the US has today. Japan also experienced far less immigration than in the US today and this factor, combined with globalization, gives US industries more options for labor utilization.

The above factors leave no doubt that Japan in the 1990s bears little resemblance to the US today. Almost all of the factors argue for a shortened and less severe post-bubble crisis. However, despite extensive studies of Japan's lost decade, economists still debate its causes and the extent to which the above factors prolonged the crisis. While there is no guarantee the US is not headed for a lost decade, our belief is the weight of evidence argues the US economy



presents its own unique set of challenges, and there is little reason to believe we will see a repeat Japan's history.

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