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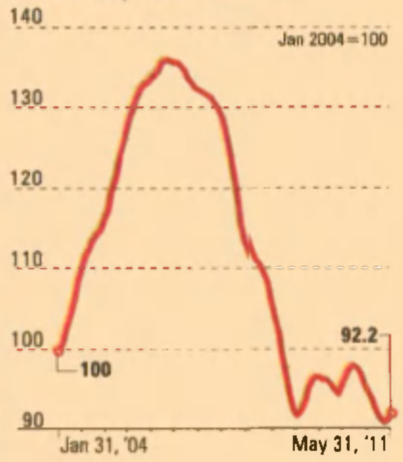
**S&P/CASE-SHILLER INDEX**

Index of house prices across the US




# THE TALE OF TWO GIANTS

## America's economic prospects are ominously reminiscent of Japan's in the 1990s, says ABHEEK BARUA

By the end of this year, it will be five years since the housing bubble burst in the US. House prices began to decline in end-2006, setting off the subprime crisis in mid-2007, which then metamorphosed into the financial sector meltdown of 2008. Though that is hardly a cause for celebration, it is an important milestone. If indeed the American economy is going through a "lost decade" on the lines of Japan, then we are bang in the middle of it. The implication, of course, is that there is more pain to come in terms of growth and employment for the US and, by extension, the global economy. Besides, there are a number of lessons that need to be learnt from the Japanese experience.

Is a comparison with Japan legitimate? Yes and no. Both recessions were triggered by the bursting of debt-inflated asset bubbles that left private sector balance sheets in tatters. The process of repairing balance sheets lasted inordinately long in Japan and threatens to do the same in the US. In Japan, private and household sector behaviour flew in the face of conventional theory as the balance-sheet recession set in. Even as monetary authorities kept interest rates close to zero, households and companies paid back their debt defying the basic tenets of profit maximisation. Thus, interest rates lost their role of equating borrowings with savings. By 1995, interest rates in Japan were close to zero, but in the decade that followed the Japanese companies continuously repaid debt. By 2005 net debt repayment rose to six per cent of GDP in Japan. In the US, despite the zero policy interest rate regime that has been in place for almost three years now, savings rates have been rising.

However, conventional wisdom had it that though their problems were similar, America's woes would not last as long as Japan's. This was premised on the fact that policy responses from both fiscal and monetary authorities in the US were more proactive than Japan. Japan, for instance, did not use large-scale monetary policy until about seven years after asset bubbles started popping. The Bank of Japan took six years to bring policy rates down to zero; the US Federal Reserve took just two. The Fed was also miles ahead in the use of unconventional monetary policy. Within four years of the crisis, the Fed's balance sheet has trebled. It took the Bank of Japan 21 years to grow its balance sheet size by this multiple. With fiscal policy too, the US was far swifter than Japan. While the Americans used expansionary fiscal policy immediately after the crisis, the Japanese government took a good seven years to put large-scale fiscal policy in place.

While the US cannot be accused of "self-induced paralysis" (Fed Chairman Ben Bernanke's oft-quoted phrase describing Japan's debacle), it is possible that it will see another five years of weak growth. That is, the US will have its own lost decade. Why hasn't more nimble policy paid off in the US? For one thing, the drop in real sector output in the US was far sharper than in Japan. Second, Japan's economic troubles started at a time when the global economy was relatively benign. The US' own problems have been exacerbated by the fact that its heavyweight neighbours like Europe and Japan find themselves in dire straits, perhaps worse than the US itself.

The most compelling reason why the US will "lose" the next half decade itself lies in the very nature of the recession. Balance-sheet recession involves a radical change in the behaviour of the private sector. In such a situation, monetary policy plays, at best, a marginal role. Thus, the degree of aggression in monetary policy becomes somewhat irrelevant to the quickness of the recovery. The only thing that is likely to do the trick is for the government to pick up the surpluses created by private sector de-leveraging and to redeploy them in the economy through aggressive fiscal policy. Japan's experience suggests that fiscal consolidation in the middle of a long-term downturn in the economy could be dangerous. A few quarters of rising growth in the mid-nineties lulled Japanese authorities into believing that the worst was over for Japan's economy. This encouraged them to tone down their fiscal stimulus in 1997 which, in turn, led to five quarters of negative growth and helped prolong the recession.

The bottom line is that for mega-recessions like this, it is imperative to keep the fiscal engines revving unless there are clear signs that the economy is on the mend. But try explaining that to the Tea Party vigilantes and the rating agencies. Despite its early success in responding to the stimulus, the US is likely to fall prey to muddle-headed economics that underpins populist politics.

There is another risk that Japan's experience points to: the delayed onset of deflation. Japan entered a phase of sustained deflation a good nine years after the crisis broke on the back of the crash in asset prices. If that is extended to the American case, the current phase of rising inflation might actually just be a little blip that precedes a sustained fall in prices. For an economy that needs to push up its levels of borrowing to drive a recovery, nothing can be worse than a decline in prices. Deflation raises the real value of debt and puts borrowers at a disadvantage *vis-à-vis* creditors. In short, deflation discourages borrowing; inflation encourages it.

Therefore, the Fed has to keep a close watch on prices. If they show the slightest tendency of softening, the Fed needs to use its monetary arsenal to reverse this. The second round of quantitative easing (QE2) was explicitly focused on fighting deflation and proved to be extremely effective. At this stage the US certainly cannot afford to take QE3 off the list of available policy options.

(I would like to acknowledge Nomura Institute Chief Economist Richard Koo's paper titled "US Economy in Balance Sheet Recession: What the US can learn from Japan's experience in 1990-2005".)

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