Written by Thomas R. Eddlem on September 1, 2010

Is America Headed Toward Japanese-style Economic "Lost Decades"?

Just one week after James Bullard of the St. Louis branch of the Federal Reserve Bank released his August 6 paper declaring that "the U.S. is closer to a Japanese-style outcome today than at any time in recent history" (meaning that the United States will likely have decades of economic stagnation, which Bullard blames on "deflation"), the news media have taken up a chorus against the bogeyman of "deflation" to explain the need for further social spending by the government and more debasement of the U.S. dollar (causing consumer prices to rise through inflation).

The Japanese economy has been mired in minimal economic growth since 1989, never reaching three percent growth per year, despite regular "stimuli" by increased government spending and borrowing. Though Japan was once a manufacturing giant, it is the service sector which now makes up three-quarters of its economy, as much of its manufacturing base has been outsourced to Korea, China, and elsewhere in East Asia.

"The terrible trap of deflation gripped Japan for nearly fifteen years after its financial collapse in 1989," Bullard claims. "Japan's economy struggled to restart, but repeatedly fell back into recession. That is one definition of Depression — an economy that cannot get out of the ditch." How bad is it? Per capita Japanese income compared with that of the U.S. has shrunk by nearly half since 1995. Imagine losing nearly half of your current purchasing power.

In Bullard's opinion, "it is conceivable to think that deflation could hurt the financial system and hamper US growth," as he notes that Japan has suffered two full decades of recession which happened to coincide with some slight consumer price deflation in the most recent decade of that recession. Consumer prices crept upward during the 1990s by about one percent and fell less than that rate during the last decade. But there's no evidence that what Bullard calls deflation — lowered consumer prices — is the culprit for Japan's depression.

On Board With a Bad Theory

Media outlets such as National Public Radio, the *Wall Street Journal*, and various wire services have contributed to the deflation alarmism, ignorantly warning that deflation necessarily means a terrible recession. Of course, the entire 19th Century of American history — one of unparalleled economic growth — was deflationary (at least in the sense that it involved lower prices for consumer goods). Prices for goods fell by almost half between 1800 and the initiation of the Federal Reserve Bank in 1913, largely as a result of increased economic efficiency through industrialization. And despite the deflationary century, no U.S. recession during that time period lasted more than four years.

What particularly worries Bullard is that for more than two years now, the Federal Reserve Bank has cut the rate at the discount window (the so-called “Federal Rate”) to nearly zero, something never before done in U.S. history, althougher Japan used the tactic frequently during its two-decade-long recession. Bullard concludes that “the conventional wisdom is that Japan has suffered through a ‘lost decade’ partially attributable to the fact that the economy has been stuck in the deflationary, low nominal interest rate…. To the extent that is true, the U.S. and Europe can hardly afford to join Japan in the quagmire.”

In a nutshell, Bullard believes that the Federal Reserve’s near-zero lending rates lead to deflation, and deflation destroys economic growth.

However, it’s a false *post hoc ergo propter hoc* argument (that an event which follows another must be the result of the first event) to claim that deflation created the Japanese depression. To begin with, suppressing interest rates to below-market levels (as the Federal Reserve has done) is inflationary rather than deflationary (it increases the amount of currency in circulation by encouraging borrowing and spending). Such an action can, however, lead to suppression of consumer prices by creating economic stagnation through a painful boom-and-bust cycle and result in lower consumer prices through consumer bargain-hunting. By definition, an economy focused upon borrowing and consumption is one not focused upon savings and investment — the latter two factors critical for economic growth.

But Bullard sees a cause-and-effect relationship between protracted suppression of interest rates and deflation, and therefore concludes that the Federal Reserve should suppress interest rates only to about two percent over a long period rather than to the current rate of zero that Federal Reserve officials have pegged.

Bullard also recommends that the Federal Reserve Bank go big with inflation to stem the supposed pox of deflation, suggesting that “a better policy response to a negative shock is to expand the quantitative easing program through the purchase of Treasury securities.” By “quantitative easing,” he means that the government would float new debt and then have the Federal Reserve buy the debt, effectively increasing the amount of currency in circulation and pushing inflation (and consumer prices) upward. “The quantitative easing program," he explains, "to the extent it involves buying longer-dated government debt, has often been described as ‘monetizing the debt.’ This is widely considered to be inflationary, and so inflation expectations are sensitive to such purchases.”

Bully for Bullard

Ironically, Bullard’s monograph for the St. Louis Federal Reserve launches a stinging attack upon the Obama Administration’s borrow-and-spend strategy for recovering from the recession, noting that this was precisely the same tactic used by the Japanese after their economic bubble burst in 1989:

> The proposal might work in a model setting, but … governments that attempt such a policy in reality are surely playing with fire. The history of economic performance for nations actually teetering on the brink of insolvency is terrible. This does not seem like a good tool to use to combat the possibility of a low nominal interest rate steady state.

Beyond these considerations, it is questionable at this point whether such a policy actually works. Japan, our leading example in this story, has in fact embarked on an aggressive fiscal expansion, and the debt-to-GDP ratio there is now approaching 200 percent. Still, there does not appear to be any sign that the economy is about to leave the low nominal interest rate steady state, and now policymakers are worried enough about the international reaction to their situation that fiscal retrenchment is being seriously debated.

This flatly contradicts not only the current White House policy, but also that embraced by numerous leftist columnists, who claim the way the U.S. must solve its current debt crisis is by aggressively taking on *more* debt. William Greider, for example, argued on NPR.com:

> Forget the stupid deficit scare-mongering. Government must embrace more aggressive fiscal measures — bigger deficits, not little bitty gestures. New stimulus spending is needed to fight off the downward pressures. That, of course, will require the President to acknowledge what he now denies. The nation is not out of the danger zone. The government must act because it is the only sector in the economy that can lead the way.

Likewise, Robert Kuttner of the *American Prospect* noted on the Huffington Post Sunday that “the appeal of austerity is fading.”

Greider and Kuttner essentially argue that the United States should follow the example of Japan. For two decades now, the Japanese government has maintained that it is the only economic actor which can lead the nation out of recession by borrowing and spending. And Japan is now second in the world only to Zimbabwe in debt-to-GDP ratio, with some 190 percent of GDP in national debt (the U.S. has increased from about a 30-percent debt-to-GDP ratio in 1980 to nearly 100 percent today). Yet, the Japanese economy remains mired in recession.

Still, most leftists continue to argue that spending is the only way to avoid a Great Depression — for example, in a recent column on the Huffington Post, former U.S. Labor Secretary Robert Reich asked:

> What to do? First, don’t listen to Wall Street and the Right. Forget the Neo-Hoover deficit hawks who say we have to cut government spending and trim upcoming deficits. We didn’t get into this mess and aren’t remaining in it because of budget deficits. In fact, the only way to reduce long-term deficits is to restore jobs and growth so government revenues rise and expenses like unemployment insurance drop.

Reich’s argument shows both economic and historical ignorance about the Great Depression. President Herbert Hoover never even attempted to balance the federal budget; rather, he and his Republican Congress increased federal spending by 40 percent, leaving Roosevelt the two largest deficits in U.S. history, after those of World War I. During Roosevelt’s first two terms, he and his Democratic Congress continued Hoover’s borrow-and-spend policies by increasing federal spending some 80 percent. The result was the Great Depression, which lasted until the demobilization after World War II — the longest economic recession in U.S. history. That Depression, like the Japanese model, involved the following policies over more than a decade: the suppression of interest rates by the Federal Reserve/central banks, huge government “jobs” programs, massive government budget deficits, and mounting national debt.

And those are precisely the policies currently being pushed by the Obama Administration.

The only solution for our economic woes is to let the free markets decide interest rates (and they would rise sharply) and to cut government spending under a balanced budget. For the time being, however, both Republican and Democrat politicians running Washington seem set against this policy.

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