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The Japanese Bubble and the US Bubble

Stephen S. Roach

Until March of 2007, Stephen Roach was the chief economist for Morgan Stanley and the analyst to read on the Morgan Stanley Global Economic Forum page. But his repeated warnings of a bubble economy about to burst went unappreciated by his paymasters and - rumor has it - many Morgan Stanley investors. Yet even as they moved Roach to the Morgan Stanley Asia desk, far away from his forum, the housing bubble he warned of was already showing strong evidence of impending collapse. Late last summer, of course, the subprime market in the financial sector slipped suddenly into meltdown mode, leaving not only homeowners in the lurch, but striking deep into the profits of the likes of Citibank. Now it seems that not only the US economy but others, too, are sliding into something truly ominous. So inside the year since Roach was silenced, we have moved from bubble-era euphoria to the growing possibilities of a major recession, and some believe even a 1930s style collapse. So Roach is clearly someone worth listening to, in this instance comparing the US with Japan's 1990s implosion.

Roach points out in this brief article that the US is in the midst of a property and stock market bubble collapse that bears "eerie similarities" to Japan's experience in the early 1990s. He argues that the US needs to look closely at the Japanese experience and learn the right lessons, especially concerning the use of fiscal policy both to prevent a full-scale slide into depression and to fix the underlying economic problems. The Japanese fiscal authorities, he points out, were slow to act, and when they did so they sought to maintain the pre-bubble economic order, directing much pump-priming towards wasteful construction. Poor policy responses in Japan, therefore, allowed the bubble's collapse to dry up credit and needlessly protracted economic misery. Learning from Japan therefore means taking fast action as well as using the state's fiscal levers to reshape the economy in ways that promise long-term vitality.

Roach wants to see the US authorities use fiscal policy to shift the economy away from over-consumption and towards exports and infrastructure investment. At present, he notes, the tax rebates and other measures are likely to prop up America's over-consumption, which is at the root of the US crisis.

There is no doubt that the US requires more public investment in infrastructure, as US civil engineers regularly rank America's infrastructure as "D" grade and argue that there is a US$1.7 trillion shortfall in essential investment. But surely public finance, even when used for pump-priming, has to have priorities. Roads and and bridges linking suburbs and city have helped to get the US into the energy and climate crises that Roach fails to mention. Perhaps Americans need to ask whether public spending might also be used to help shift the US economy further away from activities that result in excess consumption of space and energy and dangerously high levels of greenhouse gas emissions.
Is there any evidence that the US administration is considering these issues? AD

AMID increasingly turbulent credit markets and ever-weaker reports on the economy, the Federal Reserve has been unusually swift and determined in its lowering of the overnight lending rate. The White House and Congress have moved quickly as well, approving rebates for families and tax breaks for businesses. And more monetary easing from the Fed could well be on the way.

The central question for the economy is this: Will this medicine work? The same question was asked repeatedly in Japan during its "lost decade" of the 1990s. Unfortunately, as was the case in Japan, the answer may be no.

If the American economy were entering a standard cyclical downturn, there would be good reason to believe that a timely countercyclical stimulus like that devised by Washington would be effective. But this is not a standard cyclical downturn. It is a post-bubble recession.

The United States is now going through its second post-bubble downturn in seven years. Yet this one stands in sharp contrast to the post-bubble shakeout in the stock market during 2000 and 2001. Back then, there was a collapse in business capital spending, a sector that peaked at only 13 percent of real gross domestic product.

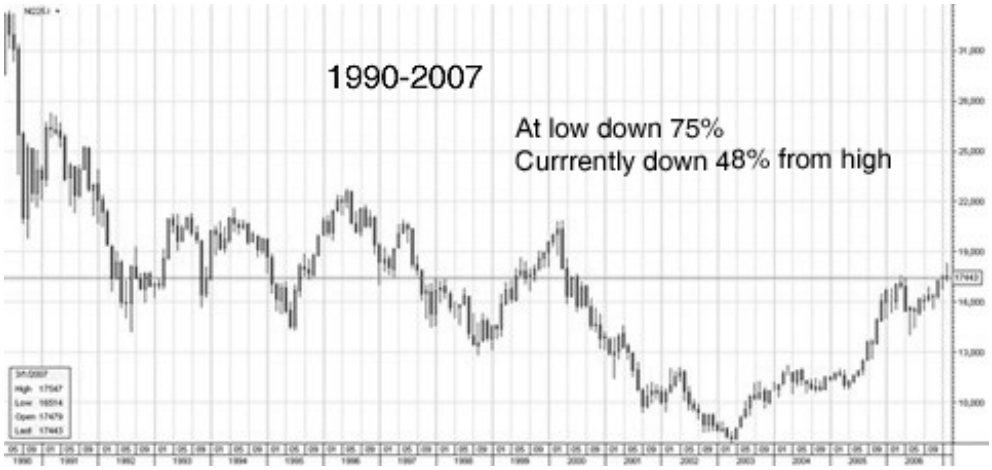
The current recession has been set off by the simultaneous bursting of property and credit bubbles. The unwinding of these excesses is likely to exact a lasting toll on both homebuilders and American consumers. Those two economic sectors collectively peaked at 78 percent of gross domestic product, or fully six times the share of the sector that pushed the country into recession seven years ago.

For asset-dependent, bubble-prone economies, a cyclical recovery — even when assisted by aggressive monetary and fiscal accommodation — isn't a given. Over the past six years, income-short consumers made up for the weak increases in their paychecks by extracting equity from the housing bubble through cut-rate borrowing that was subsidized by the credit bubble. That game is now over.

Washington policymakers may not be able to arrest this post-bubble downturn. Interest rate cuts are unlikely to halt the decline in nationwide home prices. Given the outsize imbalance between supply and demand for new homes, housing prices may need to fall an additional 20 percent to clear the market.

Aggressive interest rate cuts have not done much to contain the lethal contagion spreading in credit and capital markets. Now that their houses are worth less and loans are harder to come by, hard-pressed consumers are unlikely to be helped by lower interest rates.

Japan's experience demonstrates how difficult it may be for traditional policies to ignite recovery after a bubble. In the early 1990s, Japan's property and stock market bubbles burst. That implosion was worsened by a banking crisis and excess corporate debt. Nearly 20 years later, Japan is still struggling.



The Nikkei Stock Index 1990-2007

There are eerie similarities between the United States now and Japan then. The Bank of Japan ran an excessively accommodative monetary policy for most of the 1980s. In the United States, the Federal Reserve did the same thing beginning in the late 1990s. In both cases, loose money fueled liquidity booms that led to major bubbles.

Moreover, Japan's central bank initially denied the perils caused by the bubbles. Similarly, it's hard to forget the Fed's blasé approach to the asset bubbles of the past decade, especially as the subprime mortgage crisis exploded last August.

In Japan, a banking crisis constricted lending for years. In the United States, a full-blown credit crisis could do the same.

The unwinding of excessive corporate indebtedness in Japan and a "keiretsu" culture of companies buying one another's equity shares put extraordinary pressures on business spending. In America, an excess of household indebtedness could put equally serious and lasting restrictions on consumer spending.

Like their counterparts in Japan in the 1990s, American authorities may be deluding themselves into believing they can forestall the endgame of post-bubble adjustments. Government aid is being aimed, mistakenly, at maintaining unsustainably high rates of personal consumption. Yet that's precisely what got the United States into this mess in the first place — pushing down the savings rate, fostering a huge trade deficit and stretching consumers to take on an untenable amount of debt.

A more effective strategy would be to try to tilt the economy away from consumption and toward exports and long-needed investments in infrastructure.

That won't be easy to achieve. Such a shift in the mix of the economy will require export-friendly measures like a weaker dollar and increased consumption by the rest of the world, which would strengthen demand for American-made goods. Fiscal initiatives should be directed at laying the groundwork for future growth, especially by upgrading the nation's antiquated highways, bridges and ports.

That's not to say Washington shouldn't help the innocent victims of the bubble's aftermath — especially lower- and middle-income families. But the emphasis should be on providing income support for those who have been blindsided by this credit crisis rather than on rekindling excess spending by overextended consumers.

By focusing on exports and on infrastructure spending, we might be able to limit the recession. Such an approach might also set the stage for a more balanced and sustainable economic upturn in the next cycle. A stimulus package aimed at exports and infrastructure investment would be an important step in that direction.

The toughest, and potentially most relevant, lesson to take from Japan's economy in the 1990s was that the interplay between financial and real economic bubbles causes serious damage. An equally lethal interplay between the bursting of housing and credit bubbles is now at work in the United States.

American authorities, especially Federal Reserve officials, harbor the mistaken belief that swift action can forestall a Japan-like collapse. The greater imperative is to avoid toxic asset bubbles in the first place. Steeped in denial and engulfed by election-year myopia, Washington remains oblivious of the dangers ahead.

Stephen S. Roach is the chairman of Morgan Stanley Asia.

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