On Top of the Heap

BY JOHN M. BERRY

Compared to the eurozone, Britain, and Japan, the United States shines.

More than half a decade since the financial crisis struck, the United States, Japan, most of Europe, and many other countries are still struggling with some combination of slow or negligible growth, high unemployment, large budget deficits, and rising debt burdens. Most face only unpalatable policy choices to make things better.

Austerity—excessive austerity—has been the watchword everywhere except Japan, where government debt levels are nevertheless the highest in the world and the economy effectively stagnant. In the eurozone, austerity demanded by Germany as a condition of helping highly indebted countries such as Greece, Spain, Portugal, and Italy has helped push unemployment to a record high average of nearly 12 percent. More than one-fourth of workers in Greece and Spain are without jobs.

Against that background, it was hardly a surprise when Olivier Blanchard, the International Monetary Fund's research director, remarked in January while explaining the IMF's latest world economic forecast, "The United States is in better shape than Europe or Japan."

That view was reinforced a short time later by the Congressional Budget Office's own update of the U.S. economic and budget outlook: After four years of federal deficits of more than $1 trillion and a peak deficit of 10 percent of GDP in 2009, this year the deficit is forecast to be down to $845 billion and 5.3 percent of GDP. Moreover, with no further changes in policy, both measures are expected to be only half this year's level in 2015.

In addition, the Congressional Budget Office projected that the ratio of publicly held debt to GDP, which is expected to reach 76.3 percent this year, will remain close to that level for the next ten years.

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All that has come at a price in terms of growth and jobs, as it has in the euro countries and Britain. The hotly contested decisions to raise taxes and cut spending in order to bring deficits under better control have meant that almost no progress has been made on closing the yawning gaps between actual and potential output created by the recession that followed the crisis.

According to the Congressional Budget Office, the latest rounds of fiscal tightening in the United States will hold economic growth to only 1.4 percent this year, roughly half what it otherwise would have been. As a consequence, there will be little if any decline this year in the near-8 percent U.S. unemployment rate. Even with a sharp pickup in growth in 2014, joblessness is expected to stay above 7.5 percent through next year. If so, that would be the sixth year in a row with unemployment that high or higher—"the longest such period in the past seventy years," the Congressional Budget Office said.

In the eurozone, where there has been a far greater emphasis on austerity as a cure for the strains created by having a single currency and the huge disparities in economic conditions in different countries, unemployment is much worse. German Chancellor Angela Merkel, like most Republicans in the U.S. Congress, long ago lost sight of the fact that the ratio of a country's debt to its economic output—and thus much of its ability to service its debt—is simply a fraction. The numerator is the debt and the denominator is GDP. Spending and deficits matter but so does whether an economy is growing. And when an economy is already weak and you cut government spending, that will weaken growth further and aid unemployment.

Republicans in Congress repeatedly have rejected that simple arithmetic—except recently when they have been trying to ward off major cuts in defense spending on the grounds that will cost jobs. "Defense Keynesianism," some have called it. Now as they continue to try to reduce the size of the government, they are refusing to acknowledge what both Blanchard and the Congressional Budget Office are saying: debt and deficits are on a downward track and more fiscal tightening in the short-run would be counterproductive. Blanchard said that last year the IMF was worried that political gridlock in the United States would lead to too much fiscal tightening and stifle growth. But the year-end deal that avoided the "fiscal cliff" largely avoided that prospect.

Now the main issue for the United States "remains the need for a clear medium-term fiscal consolidation plan, but even in the absence of such a plan, fiscal consolidation is likely to proceed at a reasonable pace in 2013. If you leave aside the fiscal path, the rest of the economy shows signs of improving health," Blanchard said.

Japan is an altogether different story—as it long has been. The election of Prime Minister Shinzo Abe late last year has shaken up both monetary and fiscal policies in big ways, not all of them good. On the monetary side, Abe has strong-armed the usually cautious Bank of Japan into raising its inflation "goal" of 1 percent to a 2 percent "target." He also wants the central bank to begin a much, much more aggressive policy of quantitative easing involving the purchase of very large amounts of government bonds as part of the effort to generate more inflation. Abe's pressure on the Bank of Japan has been so great that its governor has resigned before the end of his term so an Abe supporter can take his place.

On the fiscal side, the new prime minister wants to boost economic growth by raising government spending by

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The Demand Problem

Sato's view is that the only way to be sure that inflation will turn positive is to bolster demand, something the central bank cannot do on its own when short-term interest rates are stuck at the zero bound. Over the fifteen-year period beginning in 1998, Treasury bill rates in Japan have not exceeded half a percent and more often effectively were zero. In the United States, they were above 6 percent in 2000 and above 5 just before the financial crisis hit.

—J. Berry

Takehiro Sato,
board member,
Bank of Japan

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an additional 2 percent of GDP, even though it is already borrowing more than half of what it is spending.

The immediate response has been a 20 percent drop in the value of the yen from about ¥78 to the dollar last fall to ¥93 in mid-February, which should make lagging Japanese exports more competitive. The prospect of stronger growth and more liquidity has also pushed the Nikkei 225 stock index up by about 25 percent.

The point of an inflation target and the added liquidity is to raise inflation expectations and encourage more spending and investment. However, unlike the United States, Japan has little history of significant inflation. In a widely noted February speech, Takehiro Sato, a member of the Bank of Japan's Board, ticked off a host of reasons why achieving the new 2 percent inflation target is going to be "challenging," to say the least.

Sato pointed out that from 1985 to 1995, when consumer price inflation among the other six nations in the G-7—the United States, Germany, the United Kingdom, France, Italy, and Canada—averaged 3.7 percent, it was only 1.4 percent in Japan. From 1996 through 2011 when inflation in the other six averaged 2 percent, Japan's fell by 0.1 percent. Only at the beginning of the 1990s and in the summer of 2008 have consumer prices gone up at a 2 percent rate or more, he said.

In addition, in Japan the CPI tracks very closely with workers' nominal cash wages, and after falling significantly during the financial crisis in 2009, wages have been essentially flat. "Accordingly, in aiming at the 2 percent price stability target … it is vital, above all, to seek a recovery in wages," Sato said. Such a recovery in turn would require an increase in business profits, which is unlikely "due partly to the significant decline in the competitiveness of some sectors of manufacturing," he explained.

Sato's view, in effect, is that the only way to be sure that inflation will turn positive is to bolster demand, something the central bank cannot do on its own when short-term interest rates are stuck at the zero bound. Among a fascinating array of charts that accompanied his speech, one compared three-month Treasury rates in Japan and the United States, where inflation has been higher. Over the fifteen-year period beginning in 1998, Treasury bill rates in Japan have not exceeded half a percent and more often effectively were zero. In the United States, they were above 6 percent in 2000 and above 5 percent just before the financial crisis hit.

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The other part of Abe's plan, of course, is to stimulate demand with that increase in government spending equal to 2 percent of GDP in the fiscal year beginning in April. Whether that will work is far from clear when Japan's population and workforce is shrinking by about a percent a year and households are spending less after the breadwinner retires. At the same time, private saving is falling just as government borrowing needs are increasing. That combination carries serious risks in a heavily indebted nation.

Asked about Abe's plan when he presented the IMF's outlook update, Blanchard observed, "When the country starts with a ratio of debt to GDP of much more than 100 percent—and whether we talk about net debt or gross debt, in both cases it's much above [in Japan]—and without a clear plan for fiscal consolidation over the next five, ten years, it seems to me to be quite dangerous to increase the fiscal deficit. The direct effect is still to increase spending, but it must make the markets wary about the ability of the government to actually achieve debt sustainability."

Carl Weinberg of High Frequency Economics echoed Blanchard's warning in early February. He told his clients, "The new budget shows no sign of fiscal discipline. It offers no path toward stabilizing the public sector finances. Debt service alone will consume 4.7 percent of GDP." (That compares to only 1.4 percent in the United States.) The budget deficit will be equal to more than 9 percent of GDP, and if a supplemental budget similar to the past year is added, Weinberg said, the deficit could exceed 11 percent of GDP.

Despite high and rising debt-to-GDP ratios, the Japanese government has been able to issue even long-term debt at extremely low interest rates. Economist Adam Posen, director of the Peterson Institute for International Economics, who has studied Japan for years, recently did an analysis of Abe's plans. He has praise for the quantitative easing and 2 percent inflation target by the Bank of Japan. The extra spending, even if it does stimulate economic growth, is a bad idea, he said.

"Japan was able to get away with such unremittingly high deficits without an overt crisis for four reasons," Posen wrote. "First, Japan's banks were induced to buy huge amounts of government bonds on a recurrent basis. Second, Japan's households accepted the persistently low returns on their savings caused by such bank purchases. Third, market pressures were limited by the combination of few foreign holders of Japanese government bonds (less than 8 percent of the total) and the threat that the Bank of Japan could purchase unwanted bonds. Fourth, the share of taxation and government spending in total Japanese income was low."

Posen continued, "Mr. Abe's new fiscal stimulus initiative is therefore questionable. Not because another 2 percent of GDP will be the proverbial tipping point on Japanese debt sustainability, for the factors protecting Japan from overt fiscal crisis remain. Nor because it will be ineffective; if anything, when combined with monetary expansion and a likely consumption tax rise in the near future, I expect its multiplier and thus short-run impact to be high."

Nevertheless, Posen cautioned, "Persistent fiscal policies that fail to adapt to changing cyclical conditions result in long-term damage. This holds true whether a government errs on the side of excessive austerity, as in Europe of late, or on the side of unjustified indiscipline, as in Japan since its recovery a decade ago. Either way, the consequences are real, though rarely as dramatically visible as hitting a wall," Posen said.

It's not hard to see why Blanchard said the United States is in better shape than Europe or Japan. Even though Republican conservatives have forced the nation to endure repeated budget cliffhangers, the results have been good enough to allow a modest recovery, bring down the budget deficit, and for the next several years at least stabilize the debt-to-GDP ratio. In time, unemployment should also be falling, albeit much too slowly.

The crisis that hit all the countries was centered in their respective financial systems, and there are still vulnerabilities there. European banks generally remain seriously undercapitalized and efforts to reform their regulation have a long way to go. As a consequence, lending to non-banks has contracted over the past year. In Japan, credit not related to rebuilding efforts in the north where the earthquake and tsunami hit is either stagnant or falling.

Fortunately, in this regard, too, the United States is in better shape. Reform of bank regulation is hardly complete but it is proceeding. Federal Reserve surveys show banks gradually easing terms on most types of loans and rising demand for credit. Meanwhile, the Fed's aggressive purchases of mortgage-backed securities and Treasury securities and its announced intention of keeping its overnight interest rate target close to zero until the unemployment rate falls significantly—assuming inflation doesn't exceed 2.5 percent—is helping boost asset prices while holding down the value of the dollar. Some critics fear this policy could cause a new asset price bubble or trigger a surge in inflation, but there is no serious sign of either thus far. In other words, so far, so good. ◆