Commentary

Comparing Recessions: U.S. “Great Recession” vs. Japanese “Lost Decade”

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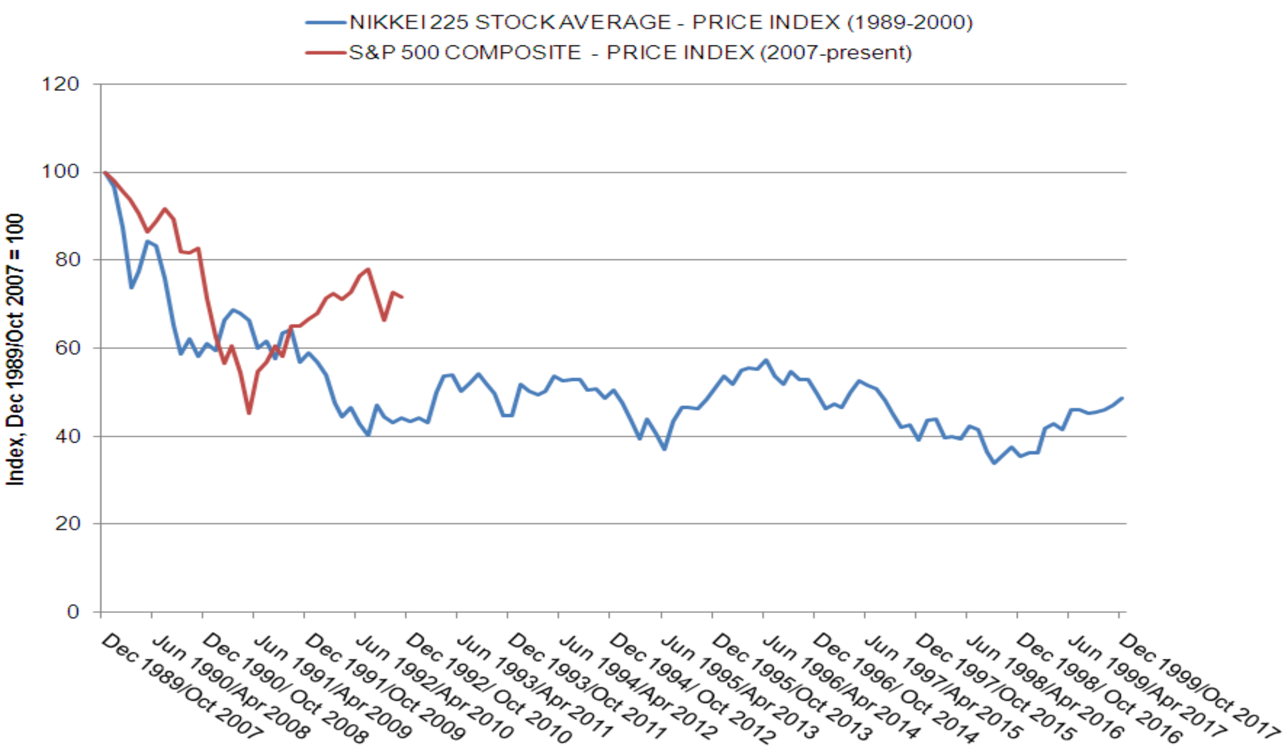
A spate of economic data during the summer months once again raised concerns that the U.S. economy is facing a “lost decade” like the one Japan experienced from 1991-2001, when Japanese economic growth practically flatlined in spite of extremely low interest rates. While we see similarities between the two situations, a closer look reveals significant differences which we believe ultimately render them uncomparable.

Exhibit 1 highlights the paths of the two countries’ stock markets. We superimposed the price return of the S&P 500 from 2007 to present over that of the Nikkei 225 from 1989 to 2000. Although the S&P 500 recorded a sharper decline during the 2007-2009 bear market than the Nikkei experienced in the first 18 months past its December 1989 peak, the U.S. market rallied briskly off its March 2009 trough. It has since turned more volatile in 2010, trading in a broad range that has frustrated bull and bear alike.

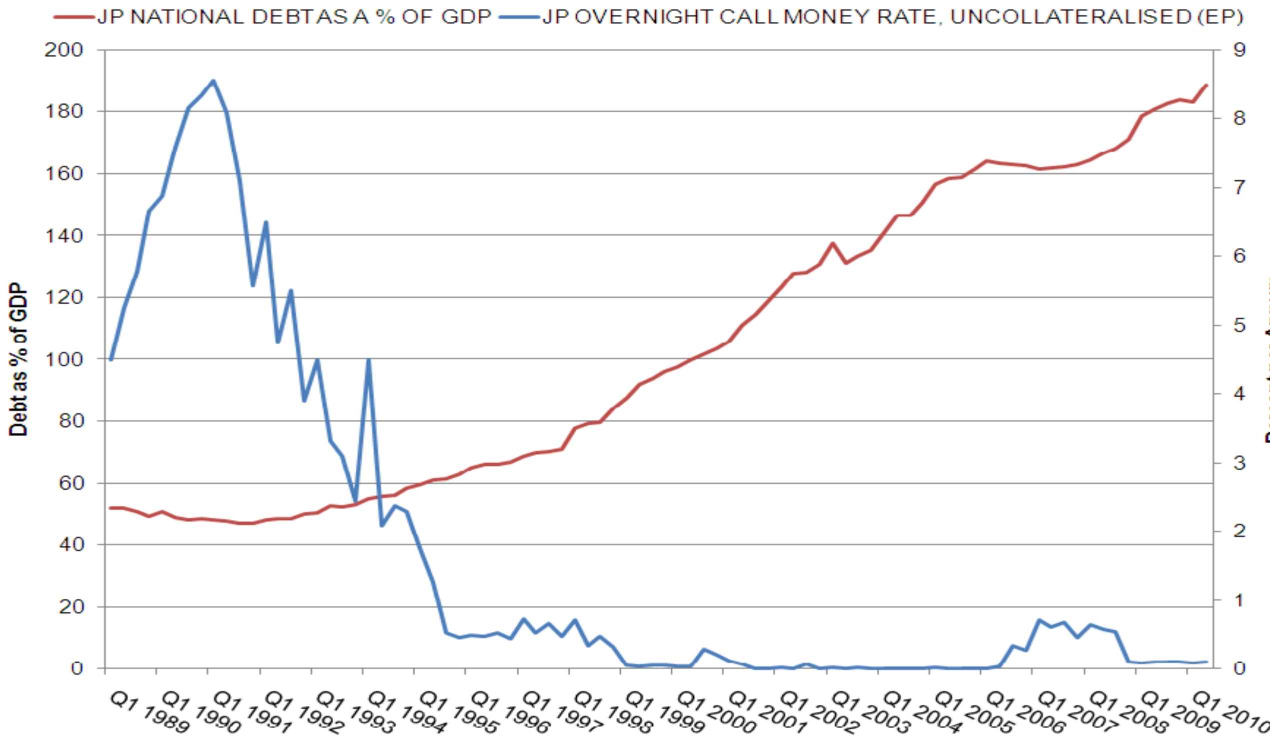
Exhibit 1: An Echo from the Past



Sources: Datastream, SEI

During the 1990s, Japan engaged in substantial fiscal stimulus, instituted a quantitative easing/zero interest-rate policy and created a bank recapitalization plan. If that sounds familiar, it is because the U.S. recently has done the same. Japan's economy, however, did not really revive until 2002, when the boom in China and other export markets got underway. Its public sector debt doubled from the mid-1990s to 2000, rising to 100% of gross domestic product (GDP). This ratio has continued to climb rapidly in recent years. Meanwhile, the Japanese overnight call money rate (the rate charged for short-term loans between banks in the banking system) fell below 1% in 1995, and has remained close to 0% for the past decade (as shown in Exhibit 2). Despite all this liquidity and stimulus, Japanese nominal GDP remains below the level that prevailed in 1992.

Exhibit 2: Japan Attempts to Reflate



Sources: Bank of Japan, Japan Cabinet Office, SEI

Why the U.S. Is NOT Japan

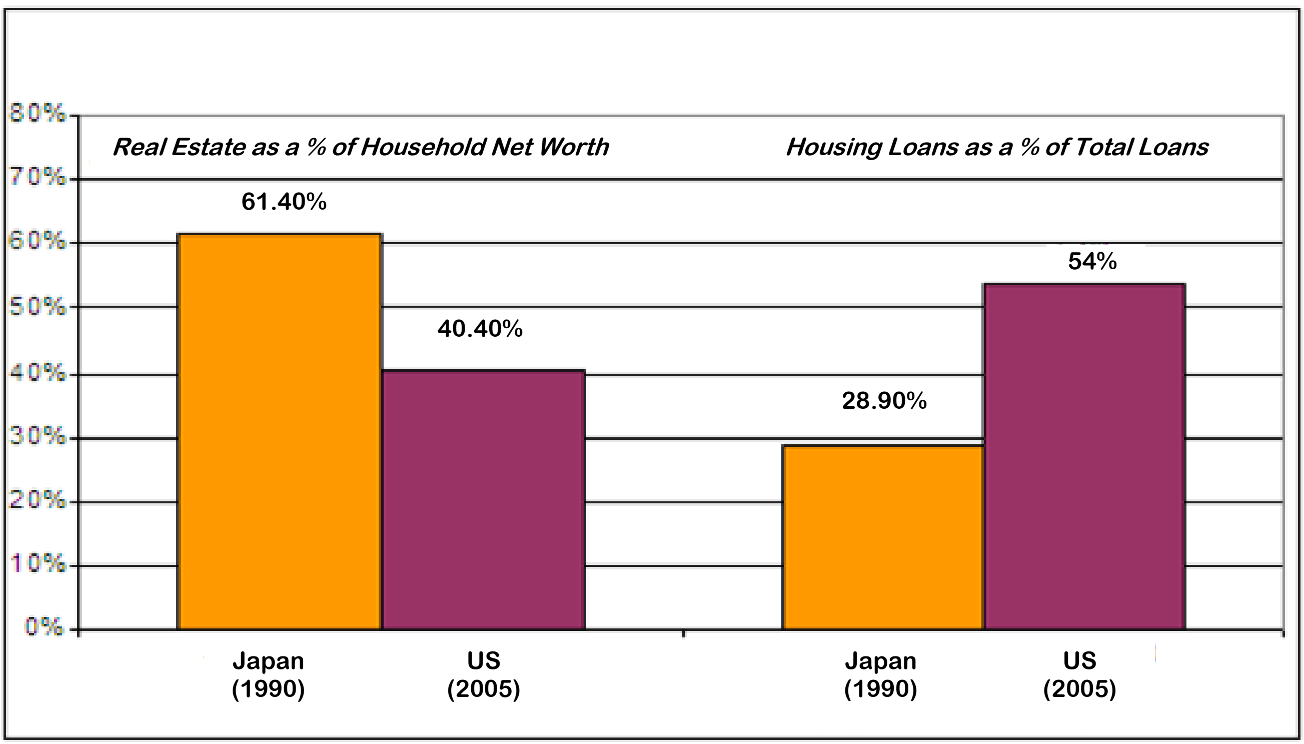
Despite the similarities between Japan and the U.S., there are substantial differences that provide reasons to be optimistic that the U.S. stock market will not wallow interminably at depressed levels. For instance, one of the common criticisms directed at the Bank of Japan's performance was its slow response to the unfolding crisis. Ten-year government bond yields were allowed to climb in the early stages (1990-91) of the Japanese recession. In addition, the fiscal policy response was dubious at times, with resources plowed into construction projects of questionable economic value (such as golf courses), as well as into unfinished or underutilized bridges and roads.

In contrast, the Federal Reserve's response to similar economic challenges in the U.S. was swifter and more far-reaching. On top of cutting interest rates in order to stimulate the economy, it bought roughly $1.5 trillion of mortgage-backed securities *and* pumped money into the system. In view of the FOMC's September 21 announcement, the Federal Reserve stands ready to reinstitute a quantitative easing strategy if economic growth continues to disappoint and inflation edges closer to the zero line.

All of Japan's other policy mistakes paled in comparison to a particularly ill-timed increase in the country's consumption tax in 1997—just months before the onset of the Southeast Asian economic crisis. Japan's economy sunk back into decline for the next two years, as consumption was dealt a heavy blow at the same time that exports declined. The United States will face a tax increase of its own at the end of 2010, when marginal tax rates are scheduled to rise. It remains to be seen if the economy is sufficiently far enough along the road to recovery to handle the increased tax burden. There is a strong consensus among policymakers that allowing all the Bush tax cuts to expire would be a grave mistake. We are assuming that Congress and the Administration will agree, at a minimum, to keep the lower and middle marginal income tax rates at current levels, and limit the increase in the top capital gains tax to 20%. The preferential rate on dividend income could disappear, however.

Another factor that makes the Japanese experience different from that of the U.S. is the size of exposure to the imploding real estate markets. In Japan, real estate was valued at a much greater share of the economy than in the U.S. In addition, real estate was a larger proportion of net worth for both households and businesses in Japan than is currently the case in the U.S. This overexposure to the asset class, in addition to the slow Japanese policy response cited above, dragged out the adjustment process far longer than necessary. On the negative side, U.S. households are more indebted, and U.S. banks have a greater share of their assets in real estate loans than Japanese banks did at the peak, as shown in Exhibit 3. This fact underscores the importance of dealing with the toxic assets that still sit on the balance sheets of financial institutions.

Exhibit 3: Peak Comparisons



Sources: Bank of Japan, Federal Reserve Board, SEI

Beyond the issue of debt, there are other considerations that argue against the idea that the U.S. is following in the sluggish footsteps of Japan. Demographics are a key element. Japan's population is aging rapidly, and is expected to decline sharply in the coming decades. The U.S., by contrast, should continue to grow, helped by immigration and a higher birthrate than prevails in Japan or many other developed countries. The average age in the U.S. is also considerably younger and rising at a slower rate.

It is also important to consider the U.S. bank bailouts, initiated during the Bush administration, which went a long way toward preventing an infestation of "zombie" banks. These institutions, which typically have a net worth below zero but continue to operate through government backings or bailouts, were one of Japan's biggest problems during its lost decade. They actually ended up preventing economic activity by hoarding large amounts of money that might have been used for loans or investments. Although the U.S. bank bailouts were unpopular at the time, they accomplished what they set out to do – namely, prevent a devastating meltdown. As a result, the U.S. financial system is slowly repairing itself, although the process still has some ways to go. That being said, there is no denying that the banking system remains somewhat dysfunctional in the U.S. in the aftermath of the credit crisis. Banks continue to sit on a vast amount of excess reserves, investing in Treasuries rather than lending the money to businesses and households. However, the situation does not appear to be as intractable as it was in Japan during the 1990s. The end result should be generally sluggish economic growth and low inflation in the years ahead, not stagnation and price deflation as recorded in Japan.

One also cannot deny the impact the recent financial crisis has had on the U.S. economy. The decline of the auto industry in this country, for example, is a sad development, as was the demise of the domestic steel industry in the 1980s. It is also likely that the country's structural rate of growth will remain subdued relative to the gains achieved prior to the crisis. This is a typical outcome following a bad financial collapse. However, unlike Japan, it should not provide a knockout blow to the overall economy. Japan, meanwhile, continues to face intense competition from other Asian exporters at a time when its currency is much stronger than policymakers would like. Over time, the country has lost market share to China and other emerging-market manufacturers. Although the U.S. naturally faces competition from abroad, its deep domestic market is an asset that provides the chief base of growth for domestic companies.

In general, the U.S. corporate sector is in far better shape than its counterpart in Japan was during the 1990s. Cash flows, returns on investment and profit margins in the U.S. rose to record levels before the onset of recession. By contrast, Japanese companies did not pay attention to what they earned versus their cost of capital; market share gains were achieved at the cost of profitability and poor deployment of assets.

Even as the "Great Recession," as it has come to be called, deepened in late 2008, American nonfarm nonfinancial corporate businesses managed to maintain a positive free cash flow position. We also would point out that, outside of the financial sector, U.S. businesses are not overly saddled with bad assets. By contrast, the Japanese Keiretsu system (a set of companies with interlocking business relationships and shareholdings) encouraged cross-holdings of equities and other corporate assets that depreciated sharply during their lost decade. This undermined balance sheets and further inhibited economic recovery.

The U.S. economy's inherent strengths limited the magnitude of the decline in GDP versus other major countries in 2009 and allowed for a cyclical recovery to develop in the second half of the year. Companies reversed the inventory cycle quickly and generated a sharp rebound in industrial production off the bottom. By contrast, the previous two U.S. recessions—1990-91 and 2001—were much milder than the recent downturn. The subsequent recoveries from those troughs were naturally mild. Unfortunately, the cyclical, inventory-induced bounce experienced to date has not generated a strong improvement in employment. Obviously, there is more heavy lifting ahead to get the U.S. economy on the right track.

Conclusion

In all, the deleveraging of the economy is a process that takes time. We expect economic growth to be slower, but we should not see the type of stagnation experienced by Japan during the 1990s (and the past decade, for that matter). Most important, we assume that U.S. policymakers have learned the lessons of Japan's lost decade. The panoply of lending facilities and loan guarantees, the decision to backstop money market mutual funds and the commercial paper market in the immediate aftermath of the Lehman Brothers collapse, the bank bailouts, etc. all helped to prevent a run on financial institutions and a true global meltdown.