Kaleidic Economics

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The Yakiniku recovery

One scenario facing the UK economy is that of the "BBQ recovery" – low and slow.[1] Compared to alternative scenarios, such as another unsustainable boom, or a debt-deflation spiral, it might be the best we can feasibly hope for. But to economists that sympathise with the Austrian school, it may actually be better than that. If NGDP growth of 5% per year is deemed high enough to generate bubbles, returning to it should not be considered ideal. Indeed consider the position attributed to Hayek:

> "The moment there is any sign that the total income stream may actually shrink, I should certainly not only try everything in my power to prevent it from dwindling, but I should announce beforehand that I would do so in the event the problem arose."[2]

This might be treated as similar to a 0% NGDP rule, which would result in any productivity gains manifesting themselves in mild price deflation. If this is the case, the "growth" enjoyed in 2002-2006 should be considered a mirage, and be replaced by a more modest rate (and indeed in NGDP terms perhaps a flat one). Those who advocate such a productivity norm (e.g. Selgin 1997) do not see all instances of falling prices as being undesirable. On the contrary, the norm of sustained inflation can cause immense economic harm. Real growth at its potential, and falling prices, would be welcome.

By the end of 2003 the level of Japan's CPI was 3% *below* the level of 1997, providing a rare, and well-known case of deflation in an advanced economy (Ito & Mishkin 2004 p.2). But this is associated with a "lost decade" of weak economic performance and is commonly used to illustrate the importance of maintaining positive inflation expectations. This paper compares some alternative assessments of what happened in Japan. Although it may be expected that Austrians, monetarists and Keynesians offer different views, there are also important intra-school debates. A better understanding of these issues might help to make sense of where the UK economy is heading.

The stylised facts

In 1990-91 Japan suffered a large stock market crash followed by a lengthy recession. Over the decade following 1993 the average GDP growth rate was just 1% (Ito & Mishkin 2004 p.2). According to

[1] The first example of this phrase being used that I've found is in 2010 by CNN, http://money.cnn.com/2010/06/29/markets/thebuzz/index.htm.
[2] See http://uneasymoney.com/2012/06/27/the-bank-for-international-settlements-falls-into-a-hayekian-trap/.

Greenwood (2006) bad monetary policy was to blame for the boom, and also the recession. He provides some useful stylised facts:

- In the 1970s the BOJ set monetary growth targets and CPI inflation then halved by the end of the decade
- This was abandoned in the 1980s in favour of foreign currency interventions. The monetary base accelerated and interest rates fell
- The Nikkei 225 index and the Japan Real Estate Institute's index (of land prices in 6 major cities) both trebled between 1985 and 1990
- The BOJ began to raise rates in May 1989, after which money supply growth began to fall (peaking in May 1990)

Greenwood (ibid) also points out that since the asset bubble didn't seem to spill over into the real economy, Japanese officials were complacent about the risks of letting it unwind. He documents the following policy responses:

1. Fiscal expansions (1990-2000)
   Policymaker's first response was a series of fiscal stimuli, which the table below summarises:

	1990	2000
Government expenditure (% of GDP)	31.8%	38.3%
Budget deficit (% of GDP)	+2.1%	-7.9%
Public debt (% of GDP)	46.8%	138.7% (by 2003)

2. Moderate interest rate cuts (1990-1993)
   Although the discount rate was cut from 6% to 2.5% this occurred over a 19-month period. The BOJ were "concerned that inflation might spread from asset prices to goods and services" ibid) and "dismissed the dramatic deceleration in money growth rates as the inevitable consequence of the desirable ending of the bubble" (ibid).
3. Moderate quantitative easing (1993-2003)
   Despite a large increase in the monetary base, "most of the growth… has been accounted for by acquisitions of foreign exchange" (ibid). Greenwood argues that low rates were a sign of weak demand rather than excess supply of loanable funds. Sustained deflation indicated that the BOJs purchase of government bonds remained on a relatively small scale, and Greenwood (2006) argues that, "the BOJ could have moved much more assertively and consistently to expand reserves and hence money growth". He continues, "the basic problem with the BOJ's quantitative strategy was that it was not aggressive enough, it was not sustained for long enough, and it completely failed to translate into any acceleration of the broader money supply" (ibid).

Since then of course further actions have been tried, more recently Shinzo Abe's plans for a 2% inflation target driven by future asset purchases. But there remains a tension relating to what we are attempting to explain. Should this really be construed as a litany of policy "failure"? Let's not forget that Japan had endured the first major banking collapse since the Great Depression. To keep inflation within a reasonably narrow band (albeit a slightly lower one than most economists would advocate) is not necessarily a disaster. Greenwood (2006) argues that eventually one would expect the Japanese economy to adapt to mild deflation, and return to the long run real growth potential. Afterall, not even the most Keynesian of models would claim that price rigidities would persist for *decades*. Although monetary policy may be culpable for keeping NGDP below 5%, this assumes that 5% is desirable. If you *want* NGDP to be flat, perhaps monetary policy should be applauded? The question then becomes whether talk of the "lost decade" is overstated - perhaps the economy was in better shape than commonly appreciated. Alternatively, even if the "lost decade" is a reality, what if the cause isn't monetary?

The lost decade?

GDP figures are a notoriously poor way to capture living standards, but not just because bureaucrats have an incentive to manipulate them. It isn't just that Soviet Russia and Communist China produce false data, but that the nature of attempting to calculate output, without being able to distinguish between economically beneficial or wasteful output, can give a misleading picture. Put simply you can't eat growth rates. Some commentators maintain that the "lost decade" is a myth. They appeal to anecdotal accounts of the general prosperity amongst the average worker. A *New York Times* article provides typical "evidence" citing William Holstein,

> "The Japanese are dressed better than Americans. They have the latest cars, including Porsches, Audis, Mercedes-Benzes and all the finest models. I have never seen so many spoiled pets. And the physical infrastructure of the country keeps improving and evolving."[3]

Whilst it is tempting to dismiss this as superficial, even on a real GDP per capita basis Japan doesn't look too bad. According to Trading Economics Japanese GDP per capita rose from under $30,000 in 1990 to over $34,000 by 1998.[4] Indeed it's grown at a similar rate than Germany:

[3] See http://www.nytimes.com/2012/01/08/opinion/sunday/the-true-story-of-japans-economic-success.html?pagewanted=all.
[4] See http://www.tradingeconomics.com/japan/gdp-per-capita

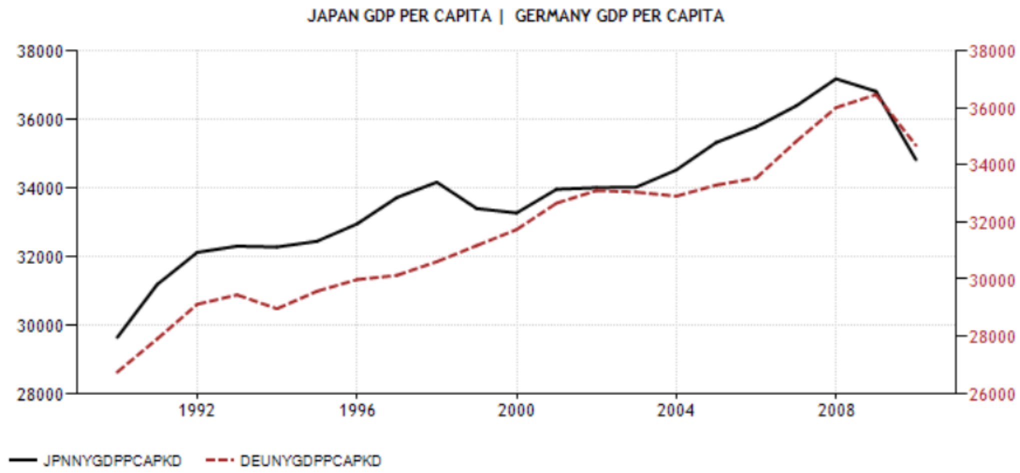

Figure 1 source: http://www.tradingeconomics.com/

And as Paul Krugman (2013) has pointed out, the "lost decade" becomes even harder to spot once you account for the declining labour participation rate - "the seemingly overwhelming failure you see if you don't take demography into account just isn't clear." A high domestic currency is bad for exporters, but make imports more affordable to domestic citizens. And ultimately the only point of production is to be able to acquire the goods and services we wish to consume. Japanese workers tend to work long hours, but many European countries look favourably on the unemployment rate throughout the supposed mire.

Non-monetary explanations

Alternatively even if we take the "lost decade" at face value, let's consider the possibility that monetary policy throughout this period has been optimal. For this to be the case, there would have to be non-monetary reasons why real growth remained so low:

- Zombie banks
  Greenwood's (2006) explanation for why the economy failed to adapt to potentially benign deflation was the lack of reforms and lack of creative destruction within the banking sector. Indeed particular problems within the Japanese banking system might also explain why the boom got so far out of hand in the first place. This is more than just a lack of political appetite to let banks fail. Japanese accounting practices differ from the US or UK which makes banks more exposed to financial panics. There are also cultural factors that may inhibit the revelation of information or confrontation of insolvency. The Olympus fraud went undetected for many years, and whilst the stereotype vision of disgraced Japanese business leaders falling on their sword has an element of truth, a lot can happen until that point is reached. Perversely,

Japan is ranked 1st globally for "resolving insolvency" by the World Bank's 'Doing Business' unit,[5] but perhaps this is because it is rarely employed.

- Large public sector

  It is telling how many of the anecdotal accounts of Japan's high living standards rest on foreigner's impressions of the cities they visit. But new infrastructure – especially that seen by wealthy tourists – is not always a good barometer. Brand new airports and bullet trains give the illusion of cutting edge technology and general prosperity. But less attention is devoted to the cost of such projects. They may sparkle, but that doesn't mean they're not malinvestment. And indeed there's an availability bias in terms of which infrastructure projects people tend to see. The bridges to nowhere, and other examples of outright waste shouldn't be neglected. Ultimately it's hard to measure the return on public infrastructure programmes and once the manner in which they are funded, and the opportunity cost of the resources being employed are factored in, multiple fiscal stimuli can be a major drag on growth. In addition, regional disparities and large fiscal transfers have the potential to harm the supply side of the economy by weakening work incentives.

- Demography and the lack of migration

  Japan's aging population (the "demographic" problem) and the growth problem are of course interlinked. One potential cure for both would be inward migration. But there is a stark contrast in terms of the legal barriers, tax treatment, and cultural tolerance between Japan and other East Asian countries such as Singapore, Malaysia and Hong Kong. An aging population should be expected to lead to higher productivity and lower growth over time. The stylised facts aren't a puzzle.

Competing schools of thought

The situation in Japan has been debated a great deal and it is unlikely that we can contribute anything original. However it is interesting to note the difference of opinions both between and within alternative schools of thought. The table below presents two of the biggest matters of judgment in terms of the lost decade narrative. The first is whether the lost decade is a myth or reality. The second is whether this is a result of either too much, or too little of a policy response.

		Policy response	
		Loose	Tight
Lost decade?	Myth	(i) ?	(ii) Kelly (2011) Krugman (2013)?
	Reality	(iii) Powell (2002)	(iv) Krugman (1998)

[5] http://www.doingbusiness.org/rankings

		Shostak (2013)	Greenwood (2006)

We have identified representative articles of each outcome, apart from the first quadrant (i). It is hard to imagine anyone arguing that Japan's economy has been fine and that this is the result of too much monetary of fiscal interventions. But there are interesting positions elsewhere. The conventional wisdom is probably contained in quadrant (iv), which claims that the lost decade is a reality, and it is the result of government inactivity. Greenwood (2006) argues that fiscal policy was detrimental, and monetary policy too tame, whilst Krugman (1998) takes a more Keynesian position. Indeed quadrant (iv) is the classic monetarist vs. Keynesian debate. That said, Krugman (1998) doesn't deny the importance of monetary or supply side policy. He lists the following, "too much corporate debt, … the refusal of banks to face up to their losses, ... the overregulation of the service sector, … the aging population" as being potentially true, and even acknowledges the point that "recovery requires tax cuts, or massive bank reform, or maybe cannot be achieved at all until the economy has painfully purged itself of excess capacity".[6] He then attempts to dismiss them, by claiming the lost decade as the manifestation of Keynes' liquidity trap. The problem with this is that he's arguing about a situation where short term nominal interest rates hit the zero lower bound. Keynes was talking about when the demand for money becomes infinitely elastic – which can happen at a non-zero interest rate. According to Congdon (2012),

> "Krugman talks about the 'short-term interest rate', by which he means the interest rate set by the central bank. Yet, Keynes' trap arises when increases in the quantity of money cannot push nominal bond yields beneath a certain level (which must be above zero) because investors have perverse expectations about the price of bonds. Krugman's trap holds when the central bank cannot, by increasing the monetary base, cut the short-term interest rate beneath zero. That leads to an unacceptably high real interest rate if people are concerned about falling prices."

The generous interpretation is that Krugman has pioneered his own liquidity trap, and is merely using Keynes as an inspiration. An alternative one is that he's muddled.

Quadrant (iii) is the classic Austrian school interpretation, which is that the lost decade was a result of too much monetary *and* fiscal intervention. Powell (2002) argues that,

> "Japan's problem, however, is not inadequate aggregate demand but a structure of production that does not meet consumers' particular demands. Producing things that nobody wants and propping up malinvestments cannot possibly help any economy."

He cites 10 fiscal stimulus projects that led to public debt that exceeded 100% of GDP as evidence for large fiscal policy (although it's important to disentangle the rise in public debt that is due to the

[6] This is Krugman's attempt to criticise the Austrian school, but it would be better to characterise this as "zombie capacity" rather than "spare capacity".

recession, from that which is due to efforts to end the recession). His argument that monetary expansion was also exhausted rests on the cuts made to the discount rate, and the large increase in the monetary base. Interestingly, he acknowledges that this didn't feed into growth in M2, and fails to elaborate on the claim that "not all monetarist approaches can be dismissed as a complete failure like Keynesian theory can". By contrast, Shostak (2013) argues from essentially the same position, but deems expansionary monetary policy (defined as the policy rate and size of the BOJ balance sheet) to be the prime cause of the lost decade. This presents an interesting debate within the Austrian school. Powell says that "the central bank has tried to reinflate" but argues that the "poor condition of the Japanese banking industry" has prevented it from doing so. In which case it is hard to maintain that monetary policy was to blame (unless you rely on a liquidity trap style argument). Powell's argument could be interpreted in two ways. Firstly, that monetary policy was ineffective and therefore shouldn't be used. Or secondly, that there wasn't enough effort made.

Whilst Shostak (2013) and Powell (2002) may have slightly different views on the role of monetary policy, they both agree that government interventions caused the lost decade, and that the lost decade was a reality. Kelly (2011), by contrast, uses the Austrian school to claim that the lost decade is a myth. His rationale relies on a lot of the anecdotal evidence mentioned above (for example "cheese is nearly ubiquitous") combined with a theoretical critique of GDP figures. Although he fails to distinguish between real GDP and nominal GDP, he argues that by counting government spending and excluding intermediate spending it fails to capture the true health of an economy. Although he perhaps overstates this argument by declaring, "GDP and economic progress are inversely related", it is interesting that he agrees with the Keynesian and monetarist view about the policy stance. He says,

> "Japan's GDP growth has been slow because [the] … BOJ, has intentionally engaged in conservative monetary policy for most of the last 20 years".

By glossing over the debt position and unemployment Kelly (2011) might be accused of painting too rosy a picture. And indeed Powell (2002) and Shostak (2013) would presumably agree with Kelly's (2011) theoretical claims – that a productivity norm is beneficial – if not his application of this to the case of Japan. Finally, Krugman (2013) is also included in quadrant (ii) because of his attempt to suggest that once you've looked into GDP in relation to the working population, Japan's situation doesn't seem so bad. It exposes an interesting tension with his earlier work about the phenomenon he is attempting to explain (i.e. whether Japan's economic performance has been relatively weak or strong), even if he doesn't touch upon whether he maintains that policy was still tight. As the famous quote about Krugman's intellectual heir goes,

> "If you put two economists in a room, you get two opinions, unless one of them is Lord Keynes, in which case you get three opinions."[7]

[7] This is attributed to Winston Churchill. I have no idea if it is true.

Conclusion

It's hard to foresee an amenable outcome to the lingering debt crises facing Japan, and indeed the UK. A BBQ economy may be desirable if debt levels are low, but low growth and high debt can quickly become unsustainable. And all of the possible escape routes have severe question marks:

- Growth – where is it going to come from, and how could it be enough?
- Immigration – even if public hostility to immigration subsided, it is hard to see how it could be enough to substantially alter the demographic trends
- Supply side reforms – there is no evidence that governments have the appetite for the wide-ranging policies that would be required
- Pension reform – thus far any attempts to confront this problem runs into the large vested interests of those who want to protect their assets. It is very hard politically to reduce entitlements to such a dominant block of voters

Perhaps the problem here is the attempt to look ahead to some sort of endgame. It is true that there's no solution on the horizon, but maybe there doesn't need to be. Events in Japan could provide useful indicators of what's in store for the UK, if we have indeed followed them onto the grill. But there is no political incentive to *solve* the problem, only to *delay* it. If the debt problem disappeared policymakers would shun BBQ in favour of high and quick growth. But low and slow growth will kick the can further down the road, and whenever a possible crisis point is reached there will probably be a political compromise to paper over the cracks. This is a pity. A BBQ economy shouldn't be seen purely as the unwelcome side effect of a high debt burden. If it wasn't for the high debt burden a BBQ economy would in fact taste pretty sweet.

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