THE ESCAPE FROM BALANCE SHEET RECESSION AND THE QE TRAP

A HAZARDOUS ROAD FOR THE WORLD ECONOMY

RICHARD C. KOO

WILEY

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To my dearest wife, Chyen-Mei

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Foreword

The global economy underwent a major ordeal after the housing bubbles in Europe and the United States burst in 2007. Almost six years have passed since the Federal Reserve followed the Bank of Japan's lead a decade earlier and took U.S. interest rates down to zero, yet the unemployment remains elevated and industrial output has only recently recovered to the levels of 2008. In Europe, the unemployment rate is running near the euro-era high of 12 percent even though the European Central Bank (ECB) also cut interest rates to zero. The picture for output is even bleaker: Although German industrial production has recovered to the levels of 2007, output in France and Spain is no greater than it was in 1994, and in Italy production has fallen back to 1987 levels. United Kingdom industrial production is no higher than it was in 1992. In Japan, which was geographically far removed from the Western bubbles, the mood has improved since "Abenomics" was launched at the end of 2012, but industrial output remains stuck at the levels of 2003. Some have dubbed this situation "secular stagnation."

Amid these economic difficulties, national policy discussions have been characterized by a severe lack of consensus. Even today, nearly seven years after the bubbles burst, the debate remains as tangled as ever. In the United States, the two main political parties are at loggerheads with each other over the fiscal deficit and the debt ceiling, and in Europe the fiscal consolidation thought to be essential to economic and credit market recovery has enfeebled the economy, with some observers warning of social unrest and a crisis of democracy itself.

National debates have also been characterized by an absence of consensus on monetary policy, with those arguing in favor of further monetary accommodation to counter deflationary pressures facing off against those who insist additional easing will lead to renewed financial imbalances or worse. Some say more structural reform is needed, while others argue that now is not the time because reforms could exacerbate already high levels of unemployment.

A similar rift in opinion can be observed on the question of nonperforming loan disposals in the banking sector. While some recommend pushing ahead with bad loan write-offs, others say that would only compound the

problem by prompting a further fall in asset prices. On the subject of the rating agencies, some believe these firms deserve a harsh lashing with the regulatory whip because they not only issued questionable ratings on subprime securities but also exacerbated the sovereign debt crisis. Others, meanwhile, insist that killing the messenger will not solve the underlying problems.

There is something to be said for all of these views. But the sharp division in expert opinion makes it difficult for even the most capable political leaders to make informed decisions. The media in many countries insist the current turmoil and economic slump are attributable to a lack of leadership, yet each offers a different policy prescription. This wide discrepancy in the views of purported experts suggests we are experiencing not only an economic crisis but also a crisis in economics. Most economists failed to predict the current crisis, and the economics profession itself has fallen into a state of complete disarray in its attempt to answer the question of what should be done.

Fortunately, the nations of the West have one thing in their favor: All of these issues—monetary accommodation, fiscal stimulus, the rating agencies, banking problems, and structural reform—were debated in Japan 15 years earlier. The debates in Japan were no less contentious than the ones currently now under way in the West, but in the end those of us in Japan (or at least I) learned that the post-bubble recession was no ordinary economic downturn but rather an entirely different kind of recession that has been overlooked by traditional economic theory.

It was overlooked because traditional theories never considered recessions brought about by a private sector that was minimizing debt instead of maximizing profits. But the private sectors in most countries in the West today are minimizing debt or maximizing savings in spite of zero interest rates, behavior that is at total odds with traditional theory. The private sector is minimizing debt because liabilities incurred during the bubble remain, while the value of assets bought with borrowed funds collapsed when the bubble burst, leaving balance sheets deeply underwater. With everyone saving or paying down debt and no one borrowing, even at zero interest rates, the economy started shrinking.

Such recessions are not new and have occurred on a number of occasions in the past, most notably the Great Depression, but orthodox economics has no name for recessions triggered by a private sector that chooses to minimize debt. So I called it a balance sheet recession. Over the past two years this term has finally gained currency in the West because there are too many recent economic phenomena that cannot be explained by orthodox economic theory but *can* be explained using balance sheet recession theory.

Nevertheless, many continue to oppose the argument that Western countries are facing the same kind of recession that Japan experienced

15 years ago. There are at least two reasons for this. One is that policymakers fear their economies will also undergo a "lost decade" like Japan's; the other is the conceit that they would never make the same mistakes that Japan did. But in many respects they are faithfully repeating Japan's policy missteps because they have not tried to learn from its experience.

The first reason stems from fear. But almost seven years after the bubbles collapsed, there are no signs Western economies are returning to a more normal footing. Conditions in Europe are still severe. Even in the United States, which opted for bolder monetary and fiscal accommodation, conditions are nowhere near where they should be according to traditional economics after keeping interest rates at zero for over six years. With the Fed pledging to keep interest rates at exceptionally low levels for years to come, the U.S. central bank is effectively saying it will take at least that long for the U.S. economy to return to normal. This state of affairs is a far cry from the situation 15 years ago, when senior officials at the Fed routinely criticized the Bank of Japan for not easing aggressively enough, insisting the Japanese economy would pick up immediately if only the central bank took a more active role.

The belief among Western officials that they would never repeat Japan's mistakes is attributable in part to substandard foreign journalists in Japan who have helped create major misconceptions overseas. Intelligent, insightful foreign correspondents are never in shortage when a nation has a strong economy and is in the global spotlight, but few seek assignments in a country with a weak economy and, it is presumed, little to teach the world. In the late 1980s, when Japan was a global economic leader, the quality of foreign correspondents was extremely high. Their knowledge of Japan was so extensive that I learned a great deal from them each time they interviewed me.

Once Japan started to lose momentum in the 1990s, however, these individuals departed for the rapidly growing economies of Southeast Asia and China. The sole job requirement for their replacements seemed to be the ability to come up with likely sounding reasons for Japan's economic slump, with many just asking foreign financial firms in Tokyo—because they spoke English—for a quick sound bite. Many of those firms, however, were in Japan to buy assets on the cheap, and anything that prevented them from accomplishing their bargain hunting was labeled an "impediment to Japanese recovery," including delays in structural reforms and bad loan disposals. Even fiscal stimulus by the government was given a bad rap because it kept the economy from collapsing and prevented the fire sale of assets.

It is said that people will believe any story that is repeated often enough, and those outside Japan, who could not see for themselves that Japan was actually suffering from balance sheet problems rather than structural problems, ended up believing that Japan's slump was attributable solely to poor

policy choices resulting from a lack of political will to implement structural reforms.

That mindset made it difficult for policymakers in the West to accept warnings and policy recommendations issued by senior Japanese officials and myself before the Lehman failure and the global financial crisis (GFC). In *Balance Sheet Recession—Japan's Struggle with Uncharted Economics and Its Global Implications* (John Wiley & Sons, Singapore, March 2003), I warned that a housing-bubble-dependent U.S. economy could eventually fall into a severe balance sheet recession. And about six months before the collapse of Lehman Brothers, then–Japanese finance minister Fukushiro Nukaga recommended to Treasury secretary Hank Paulson that the United States quickly inject capital into distressed financial institutions. Both warnings, unfortunately, went unheeded. Had the U.S. authorities listened to my warning and implemented Mr. Nukaga's proposal, the severity of both the balance sheet recession triggered by the housing bubble collapse and the financial crisis sparked by the Lehman bankruptcy could have been lessened substantially.

In the same book I also warned that in the event of a balance sheet recession, Europe—where governments' hands are tied by the Maastricht Treaty, which makes no allowance for the possibility of such a recession—would be hit much harder than either Japan or the United States. Unfortunately, this projection also turned out to be prescient. Making matters worse, many European officials misdiagnosed balance sheet problems for structural problems, first in post–IT bubble Germany, then in post–global financial crisis (GFC) peripheral countries, prolonging recessions in both cases.

In this book I will begin by discussing the similarities between Japan in the past and the West today. I will then present the basic mechanics of balance sheet recessions with a focus on theoretical aspects before returning to recent developments in the global economy. The book will also cover quantitative easing or QE, which is one of the problematic policy byproducts of a balance sheet recession and its aftermath, the QE trap.

It is said that there is no Democratic or Republican way of collecting garbage. Once the disease is correctly identified and its treatment is made known, the extreme social and political polarization that has characterized the United States and other countries over the past seven years should subside. Once a patient is diagnosed as having pneumonia, for example, the treatment is basically the same anywhere in the world. Although it may be years before the general public is made fully aware of this economic malady, I am encouraged that more and more people and organizations—including the International Monetary Fund (IMF) and the Bank for International Settlements (BIS)—are coming to appreciate the concept of balance sheet recessions. It is my hope that readers will leave with a deeper understanding of the problems faced by Western economies today and a better idea of how

to overcome this predicament in light of Japan's experience over the past 20 years.

Notes on the Data Used in This Book

- The data used in this book are current as of June 30, 2014.
- Within the text, there are many references to the data as they were released originally. Many if not most of these data were subsequently revised repeatedly, but revised data typically have far less impact on the markets or the policy debate. Since it was the initial releases that drove changes in both asset prices and subsequent policy, the text refers to the statistics that changed history, not the revised numbers that may be in the database now. However, when revised numbers shed light on what was earlier seen as a puzzle, the revisions are mentioned as well.
- The United States is the only developed economy to provide seasonally adjusted flow-of-funds data. For other countries, I used four-quarter moving averages to capture the trend in the case of national data. For sectoral data in individual countries, the X-12-ARIMA package was used to obtain seasonally adjusted values for gross financial asset and liability flows. The additive seasonal adjustment mode was used since these flows are sometimes negative.

About the Author

Richard C. Koo (Tokyo, Japan) is the Chief Economist of Nomura Research Institute, with responsibilities to provide independent economic and market analysis to Nomura Securities, the leading securities house in Japan, and its clients. Before joining Nomura in 1984, Mr. Koo, a U.S. citizen, was an economist with the Federal Reserve Bank of New York (1981–1984). Prior to that, he was a Doctoral Fellow of the Board of Governors of the Federal Reserve System (1979–1981). Best known for developing the concept of balance sheet recession, he has also advised several Japanese prime ministers on how best to deal with Japan's economic and banking problems. In addition to being one of the first non-Japanese to participate in the making of Japan's five-year economic plan, he was also the only non-Japanese member of the Defense Strategy Study Conference of the Japan Ministry of Defense for 1999 to 2011. Currently he is serving as a Senior Advisor to the Center for Strategic and International Studies (Washington, D.C.). He is also an Advisory Board Member of the Institute for New Economic Thinking (New York City), and a charter member of the World Economic Association.

Author of many books on Japanese economy, his last book, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession* (John Wiley & Sons, 2008), has been translated into and sold in five different languages. Mr. Koo holds BAs in Political Science and Economics from the University of California at Berkeley (1976), and an MA in Economics from the Johns Hopkins University (1979). From 1998 to 2010, he was a visiting professor at Waseda University in Tokyo. In financial circles, Mr. Koo was ranked first among over 100 economists covering Japan in the Nikkei Financial Ranking for 1995, 1996, and 1997, and by the *Institutional Investor* magazine for 1998. He was also ranked first by Nikkei Newsletter on Bond and Money for 1998, 1999, and 2000. He was awarded the Abramson Award by the National Association for Business Economics (Washington, D.C.) for the year 2001. Mr. Koo, a native of Kobe, Japan, is married with two children.

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