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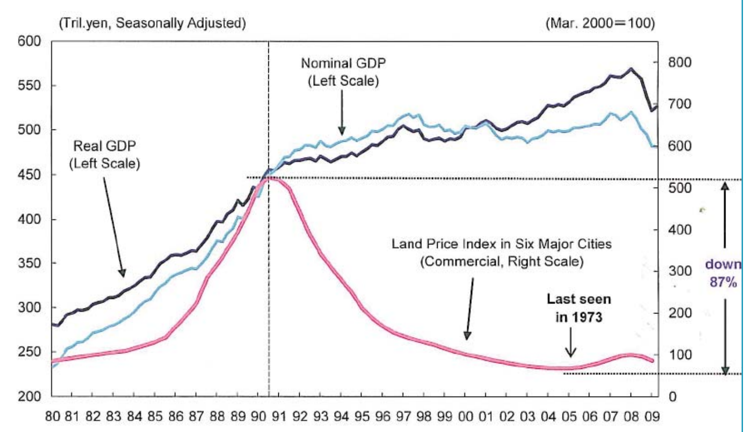
listeningin

KOO's "Good News"

Nomura Economist Says GDP Needn't Fall In "Balance Sheet Recession"

NOMURA

Exhibit 14. Japan's GDP Grew even after Massive Loss of Wealth and Private Sector Rushing to Pay Down Debt



Sources: Cabinet Office, Japan Real Estate Institute

Provocative, insightful, groundbreaking, brilliant...ever since last February, when I raced through the copy of **Richard C. Koo**'*s latest book that a friend had just given me for my birthday, I've been chomping at the bit to interview the chief economist at the* **Nomura Research Institute**. *But Richard works in Tokyo, travels incessantly and some things just take time. Which, as it happens, is the same thing, along with loads of sustained, speedy and substantial fiscal stimulus, that he argues is required for an economy to work itself out of a "balance sheet recession" with a minimum of self-inflicted damage. Koo's theory and his prescriptions for what currently ails the world are as fascinating as they are unconventional. Considering the woeful track record of orthodox economists (across the entire spectrum from liberal to conservative) in diagnosing, much less treating, the body economic as it has been wracked with credit ills, Koo's fresh perspectives, grounded in the searing experience of Japan's Great Recession, demand careful consideration.*
KMW

You called your book, *"The Holy Grail of Macro Economics, Lessons from Japan's Great Recession,"* yet I imagine the first reaction you hear from a lot of Americans is that the U.S. isn't Japan. That the cultures are far too different for this country to learn anything from Japan's miserable post-bubble economic journey.

Right, I can't tell you how many times I have experienced that. But ever since **Martin Wolf** mentioned my book in his column in the *Financial Times* last January, I've found that suddenly the whole world has been paying a lot more attention.

It never hurts to have your book called "brilliant" by someone who knows his stuff.

A lot of people had read it before Martin Wolf mentioned it, and had told me that they found it extremely useful. Economists like **Laura Tyson.**

welling@weeden

Kathryn M. Welling
Editor and Publisher
welling@weedenco.com

Published exclusively for clients of Weeden & Co. LP

Lance Lonergan
National Sales Manager
(800) 843-9333 or
(203) 861-7670
lance@weedenco.com

Thomas Orr
Director of Research
(800) 843-9333
tom_orr@weedenco.com

Noreen Cadigan
Director of Research Sales
(203) 861-7644
ncadigan@weedenco.com

Jean M. Galvin
Business Manager/Webmaster
(203) 861-9814
jean_galvin@weedenco.com

Karin-Marie Fitzpatrick
Editorial Assistant
fitz@weedenco.com

Subscriptions:
Pat Quill
(203) 861-9317
pquill@weedenco.com
Deirdre Sheehan
(203) 861-7636
dsheehan@weedenco.com

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But since Wolf's piece came out, I've been invited to give presentations to numerous governments around the world, trying to explain what actually happened to Japan and why something similar can happen in other parts of the world, as well.

Which ones?

The Dutch government was the most anxious to see me. They said, "Just come over. We'll pay for everything." So I made that trip. Spent two full days with a few ministers and many top-ranking bureaucrats, talking about balance sheet recessions. I have also been invited to the Bank of England's policy round table. I was invited by the Central Bank of Kazakhstan, by Poland. I've done a presentation for the English Finance Ministry; one to Australia's Treasury.

The U.S. is conspicuous in its absence from that list.

Well, the U.S. government hasn't invited me to do anything directly – yet. However, I go to Washington once a year because I used to have a very generous doctoral fellowship from the Board of Governors of the Fed in the early '80s, and it is my way of paying back that debt. Every year, I give a presentation to the Fed. I must say that for a long time, ever since I started talking about this concept of a balance sheet recession, I was bashed and bashed and bashed, every time I'd give a seminar at the Fed. Only in the last three years or so have they begun saying, maybe you are right that this kind of thing can actually happen. But many Fed staffers now are aware of my argument and what has to be done to deal with balance sheet recessions. Meanwhile, the CSIS, the **Center for Strategic International Studies**, which is really more of a national security, rather than an economic, think tank, has also invited me to present at two big events it has sponsored in Washington. The most recent, last year, exposed a lot of Congressional staffers to my ideas. So, at least some people in the capital are aware of what I have been saying. What's more, I've recently seen a major change in tone from **Larry Summers**, the director of the White House National Economic Council. Even though he endorsed my book which argues that once you have a balance sheet recession you have to have fiscal stimulus centered on government spending for the *entire* duration of the period in which the private sector is minimizing debt, Larry actually was promoting, until not too long ago, the idea of the "three T's." Saying that fiscal stimulus had to be "targeted, timely and *temporary*." That last part of his argument, "temporary," is extremely dangerous in this type of recession.

Why do you say that?

Because until the private sector is finished repairing its balance sheets, if the government tries to cut its spending, we're going to fall into the same trap President **Franklin Roosevelt** fell into in 1937, and that Prime Minister **Ryutaro Hashimoto** fell into in 1997, exactly 70 years later.

- **A balance sheet recession emerges after the bursting of a nationwide asset price bubble that leaves a large number of private-sector balance sheets with more liabilities than assets.**
- **In order to repair their balance sheets, private sector moves away from profit maximization to debt minimization.**
- **With the private sector de-leveraging, even at zero interest rates, newly generated savings and debt repayments enter the banking system but cannot leave the system due to the lack of borrowers. The sum of savings and debt repayments end up becoming the leakage to the income stream.**
- **The deflationary gap created by the above leakage will continue to push the economy toward a contractionary equilibrium until the private sector is too impoverished to save any money (=depression).**
- **In this type of recession, the economy will not enter self-sustaining growth until private sector balance sheets are repaired.**

The economy will collapse again and the second collapse is usually far worse than the first collapse. And the reason is that, after the first collapse, people tend to blame themselves. They say, "I shouldn't have played the bubble. I shouldn't have borrowed money to invest – to speculate – in these things. But a second collapse affects everyone, not just the bubble speculators, and it also suggests to the public that all the efforts to fight the downturn up to that point – all the monetary easing, the low interest rates, quantitative easing – they all failed and even fiscal policy failed. Once that kind of mind set sets in, it becomes 10 times more difficult to get the economy going again. So the fact that Larry was talking about "temporary" fiscal stimulus had me very, very worried. That whole Larry Summers idea that one big injection of fiscal stimulus will get the U.S. out of the recession and everything will be fine thereafter probably led to **President Obama** saying he's going to cut his budget deficit in half in four years.

Too optimistic, you're saying?

My view is that, if this is a full-fledged balance sheet recession and we see U.S. households increasing savings rates and deleveraging happening all over the economy, it will be very difficult to convince people to change that behavior quickly. Because with everybody doing it all at the same time, the economy will be weak, asset prices will be weak and that just pushes the goal of repairing private sector balance sheets even further away. Once the U.S. has fallen into this type of recession, it will be in there for a while – and fiscal stimulus will be needed for the whole period, if you want to keep GDP from falling.

Let's back up for just a second here and explain what you mean by a "balance sheet recession." What made the Great Depression and Japan's Great Recession different, in your view, than the garden variety cyclical recession?

The key difference is that in the typical cyclical recession, private sector balance sheets are *not* badly affected and people, at the most fundamental level, are still forward-looking. So, when you bring interest rates down and people are still trying to maximize profits, there will be some response to those lower interest rates. People borrow money, they purchase something and the economy starts moving forward.

But, in a balance sheet recession?

In these cases, after an asset pricing shock, after a bubble bursts, the private sector's balance sheets are under water. When that happens, the first priority of people in the private sector becomes *to minimize debts* instead of to maximize profits and if there are enough underwater balance sheets around, even if you bring interest rates down to zero, still nothing happens. People with balance sheets under water will not be increasing their borrowings and there won't be too many willing lenders to those guys, either. So the effectiveness of monetary policy goes out the window, exactly as happened during the Great Depression in the U.S. and in Japan during the 1990s – and as is happening in the U.S. this time around. It's a case of actions that are perfectly rational on the micro level turning disastrous when engaged in at the same time by an entire economy.

So there's a fallacy of composition at work?

Exactly. But the government cannot tell people *not* to repair their balance sheets, right? The private sector *must* repair its balance sheets before outsiders find out how bad its financial health actually is. In order to retain credit ratings and so forth, the private sector has no choice. It *has* to repair its balance sheets by paying down debt. My argument is that, if the government did nothing to counter this situation, the economy would shrink very, very rapidly. Debt repayment and the savings of the private sector would end up stuck in the banking system because there would be no borrowers even at very low interest rates. So the economy will be losing demand equivalent to household savings plus corporate debt repayment each year. That is how I think the U.S. got into the Great Depression in the 1930s. But the ray of hope here is that *if the government comes in and borrows the money which now is just sitting in the*

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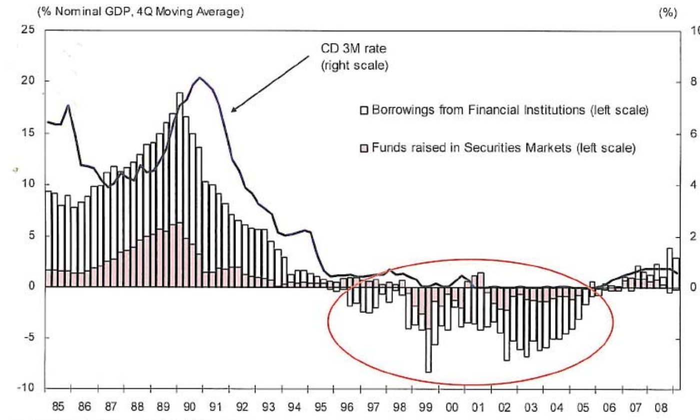
Exhibit 9. Balance Sheet Problems Forced Japanese Businesses to Pay Down Debt even with Zero Interest Rates

Funds Raised by Non-Financial Corporate Sector



Sources: Bank of Japan, Cabinet Office, Japan

banking system and puts it back into the income stream through government spending, then there's no reason for GDP to fall. That's what is needed in times like this, when the government cannot tell the private sector not to repair its balance sheets.

If I understand you correctly, you're arguing that everyone who has been worried about a credit crunch has everything exactly backwards? The problem isn't the banks' inability or refusal to lend; it's that no one wants to borrow?

Not quite. A balance sheet recession is always a two-front war: One front on the real side of the economy and the other on the financial side of

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Exhibit 18. Four Kinds of Banking Crises and Their Remedies

		Yang Normal demand for funds	***Yin*** Weak or non-existent demand for funds
Banking Crisis	Localized	(I) Quick NPL disposal Pursue accountability	(III) Normal NPL disposal Pursue accountability
	Systemic	(II) Slow NPL disposal Fat spread	(IV) Slow NPL disposal Capital injection

Type (I): 1989 S&L crisis

Type (II): 1982 Latin America debt crisis, nationwide credit crunch in the US between 1991 and 1993, and the Nordic banking crisis in the early 1990s

Type (III): Japan prior to 1995 (for example, problems at two credit cooperatives)

Type (IV): Japan since 1996, Taiwan since 2000, the US Great Depression of the 1930s, ar US and UK subprime crisis since 2007

Source: Richard Koo, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*, John Wiley & Sons, Singapore, 2008

the economy. On the financial side, with asset prices collapsing, you end up having massive banking crises. We had that in Japan in 1997-1999 [Exhibit 19] and you just had it in the U.S. in the last two years. When that happens, the banks' capital-to-assets ratios are impaired, and they can't lend to the private sector, even if they have willing borrowers and want to lend. In this situation, when the government presents itself as the borrower of last resort, the banks with capital problems should be more than happy to lend to the government, because they don't have to hold as much capital against government loans. The upshot is that governments get to borrow at ridiculously low rates during a balance sheet recession. This is basically the market's way of saying that if there is anything left in your country to do, in terms of physical or social infrastructure, education or whatever, *do it now*, because this deficit spending won't crowd out private sector investment. Not only that, but it will actually help the money supply.

***Help* the money supply? How so?**

This is Econ 101. If everyone is deleveraging, what happens to money supply? Money supply is basically made up of bank deposits. When people use money to pay down debt, they withdraw money from their bank accounts and pay it back to the banks. So deposits, money supply, shrink. During the Great Depression, as **Milton Friedman** and **Anna Schwartz** observed, U.S. money supply shrank by 33%. They attributed this contraction to bank runs and bank failures that wiped out the savings of many Americans. The implication was that if only the Fed had injected more reserves, the banking crisis – and the entire Great Depression – could have been avoided. But a closer look at the data, from the perspective of my balance sheet recession theory, produces a very different explanation of why money supply collapsed – it was almost entirely due to people paying down debt.

What data are you talking about?

The Board of Governors of the Fed in 1976 estimated that deposits lost in Depression-era bank closures and through increased hoarding of cash outside of the banking system explained just 15% of the almost $18 billion decline in deposits during the period. Meanwhile, bank lending to the private sector plunged 47%, or by almost $20 billion, from 1929 to 1932. The conventional wisdom is that lending fell because banks panicked in response to dwindling reserves and forcibly called in loans. But that same Fed study shows that bank reserves did not actually fall during that period, when borrowings from the Fed are taken into account. In addition, a survey of almost 3,500 manufacturers, undertaken in 1932 by the National Industrial Conference Board, showed that fewer than 15% of the firms surveyed reported any difficulty in their dealings with banks.

If bank closures, cash hoarding and heartless bankers didn't cause the Depression, what did?

There's only one possible alternative explanation for that era's dramatic shrinkage in deposits and loans – or, at least, for the 85% of those shrinkages that can't be attributed to the traditional villains. And that is that firms were reducing their debt *voluntarily*. At that time, the Fed tried to increase money supply by pumping reserves into the system, but with everyone paying down debt, the multiplier was actually negative, so it produced no results whatsoever.

And companies became hellbent to pay down debt because —

The price of assets purchased with borrowed funds (as most had been, during the Roaring '20s) collapsed after the stock market crash, and companies' leverage had already gotten extremely high *before* the Crash. In other words, companies in the 1930s faced the same balance sheet problems as Japanese firms confronted in the 1990s. The lesson we learned from our experience in Japan is that with the government borrowing and spending money, the money multiplier will stay positive, and that's basically how Japan kept its GDP growing throughout its Great Recession. So we have a situation where fiscal policy is actually controlling the effectiveness of monetary policy. It's a complete reversal of what almost everyone alive today learned in school – that monetary policy is the way to go. But once everyone is minimizing debt instead of maximizing profits, all sorts of fundamental assumptions go out the window.

I'm guessing that working at the Fed in the early 1980s helps explain your familiarity with data in a *1976* Fed study?

That, and a lot of research. I will note that I have more than a fair share of banking crises under my belt. In no time after I started at the NY Fed in 1982, there was a massive banking crisis, the Latin American debt crisis. I don't know how I got so lucky, but I was in charge of Latin American debt at the NY Fed at the moment that Mexico decided to default on its debt. So I learned a lot about how the U.S. government worked, or more precisely, about how **Paul Volcker**, over time, managed that situation, because I was the one who had to execute all of the actions ordered in Washington.

In case you've forgotten what happened in August 1982, when Mexico went belly up, it actually wasn't just Mexico, but *all* of Latin America, from the Mexico-Texas border all the way down to the southern tip of Chile. Seven of the 8 money center banks were actually insolvent at that point. It was a systemic crisis equal in magnitude to what we face today. Ten times larger, in fact, than the S&L crisis in the 1990s, which many more people remember and want to compare today's experience to. But the S&L crisis, which was resolved through the RTC, rela-

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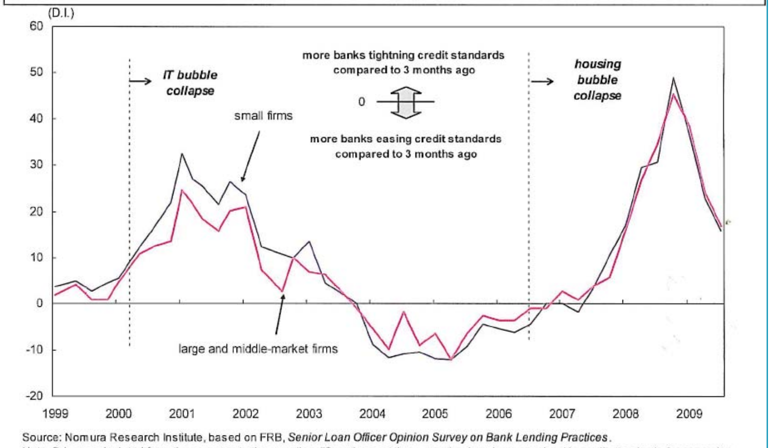
Exhibit 8. The Number of US Banks Tightening Lending Standard Is Still Increasing



Source: Nomura Research Institute, based on FRB, *Senior Loan Officer Opinion Survey on Bank Lending Practices*.
Note: D.I. are calculated from the answers to the question, "Over the past three months, how have your bank's credit standards for approving applications for C&I loans or credit lines changed?"

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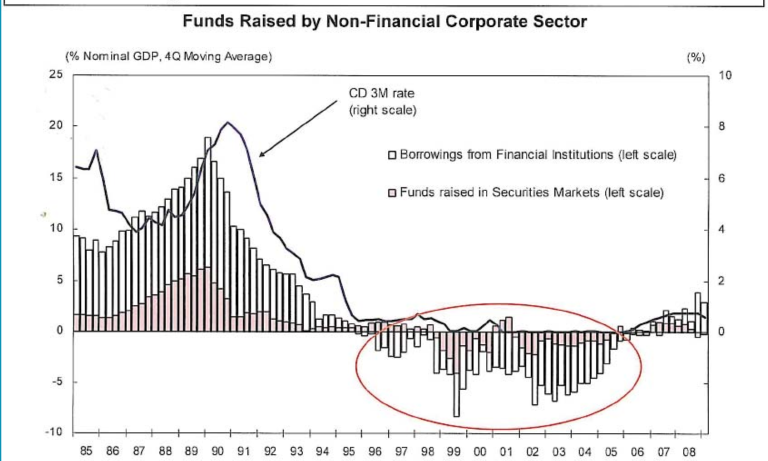
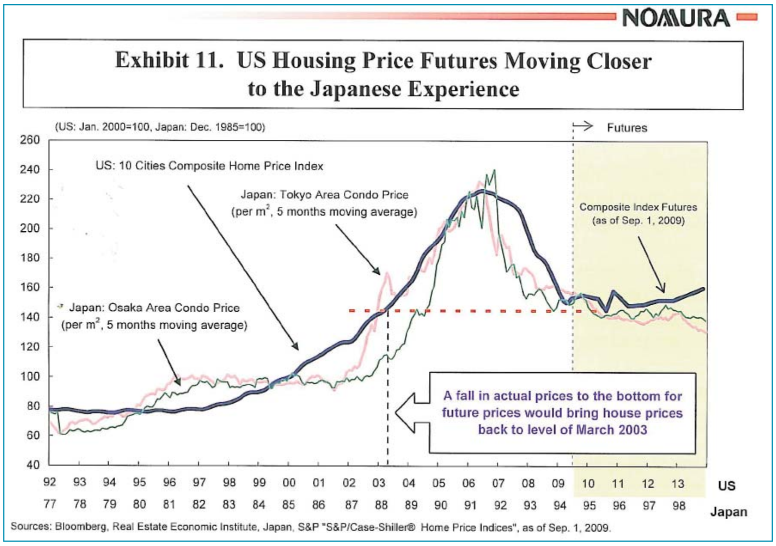
Exhibit 9. Balance Sheet Problems Forced Japanese Businesses to Pay Down Debt even with Zero Interest Rates



Sources: Bank of Japan, Cabinet Office, Japan



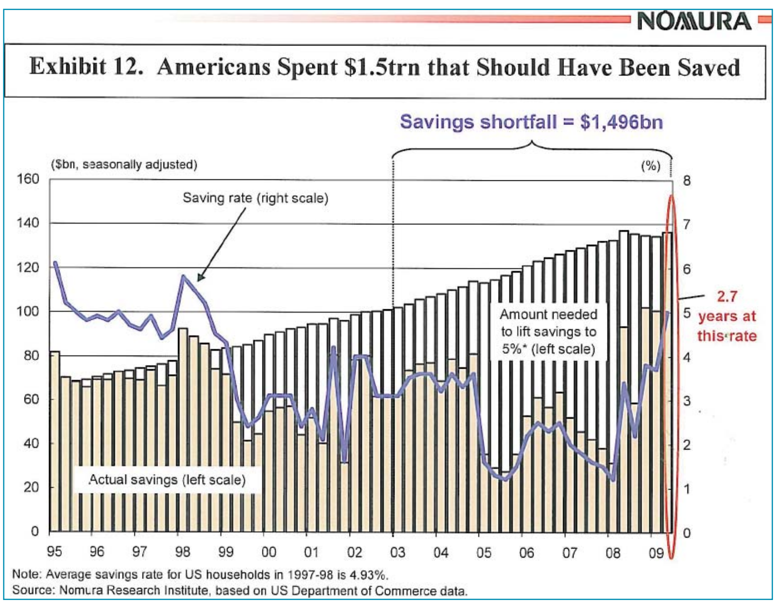
tively quickly and for a relatively modest $160 billion of taxpayer money, was a different sort of banking crisis, because systemic demand for funds at that time was normal. The Latin American credit crisis, in contrast, was so large – systemic – that it took Paul Volcker 10 or 12 years to solve. But it cost the taxpayers zero. It was so large, and so systemic, that it could not be solved by dumping those assets on the market, because there were no buyers left. Everyone had the same problem at the same time. And I was on the front line, handling it for the Fed. Then, when I moved to Japan, I was again faced with handling the systemic banking crisis that quickly evolved here.

So out of those experiences, you came to the explanation in your book that there are really four different kinds of credit crises, and each one calls for a different mix of remedies?

That's right. It depends on whether the overall economy is in what I call a Yang or Yin state, with normal or depressed demand for funds, and whether the crisis is local or systemic. [Exhibit 18]. The thing is, in any kind of a credit crunch, when bankers are not lending, it's always front page news; those horrible bankers are screwing all of these small and medium-sized firms, these poor consumers. But when the borrowers are not borrowing money, it's never front page news. Instead, any erstwhile borrowers want to keep their heads low, especially if the reason that they are not borrowing is that they have too much debt already. They definitely don't want to publicize that fact. So while attention most often is paid to a credit crunch, the real problem in an economy may be a lack of borrowing, not a credit crunch [Exhibit 7].

Since you're referring me now to a chart of demand for funds in the U.S., you're saying that's what's going on here?

Yes. Then too, as my other chart taken from that same FRB survey of senior loan officers shows [Exhibit 8], a credit crunch can be going on at the same time that loan demand is falling. So we have both problems, borrowers disappearing and then the bankers not lending. Those are the kinds of problems we actually had in Japan, as you can see in [Exhibit 9], my chart of the funds raised by Japan's non-financial corporate sector, going back to 1985. During the bubble years of the late 1980s, demand for funds skyrocketed and the BOJ tightened monetary policy to clamp down on this booming economy. Then the bubble burst in 1990, and demand for funds started falling. As the BOJ saw demand weakening, it brought rates down from almost 8% to nearly zero by 1995. But look what happened to demand for funds. It went into negative territory. Which meant that the Japanese corporate sector as a whole was paying down debt, even with zero interest rates. And it stayed negative for a full 10 years. I don't think there are any economic textbooks or business books anywhere in the world (except, now, mine) that suggest companies will pay down debt when interest rates are zero. They're not supposed to do that. If companies are paying down debt when interest rates are zero, conventional wisdom says these corporate executives are so stupid that they can't find good uses for the money. They should



be returning money to their shareholders to use somewhere else. Companies that dumb aren't supposed to exist. But look what happened in Japan for a full 10 years; the entire corporate sector paid down debt.

And you're not suggesting the whole country took stupid pills—

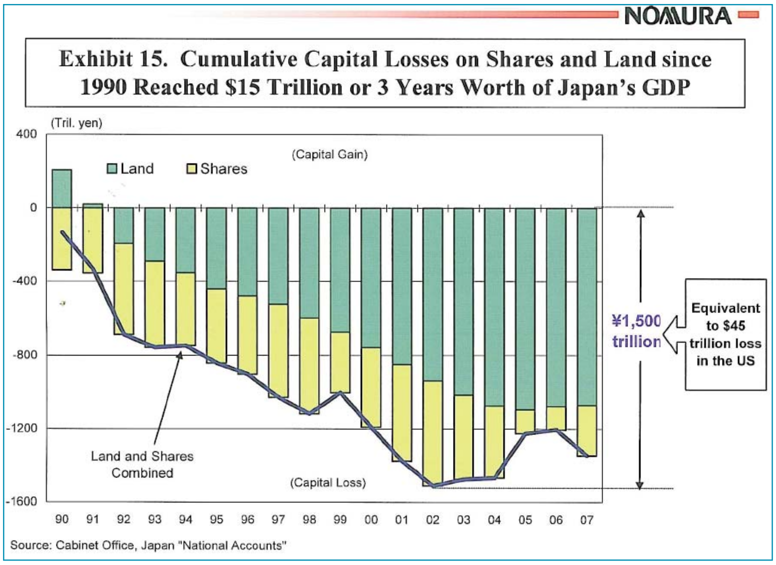
Hardly. The reason was that Japan suffered a massive collapse in asset prices, the bursting of the bubble. A lot of Japanese companies, and individuals, too, got into the bubble in the late 1980s with borrowed money. They leveraged up to invest in all sorts of assets, thinking they were going to make all sorts of money. Once the bubble burst, asset prices collapsed, but liabilities remained, and they realized their balance sheets didn't work. Well, when you're in that situation – but with your main line of business still doing well (during most of this period, remember, Japan was running the biggest trade surplus in the world; demand for Japanese cars, cameras, technology was fine) what should a corporate executive do? It doesn't matter whether he's Japanese or Chinese or American, the right thing to do is to use the company's cash flow to repair the balance sheet. Because what's the alternative? If he just says, "Sorry, we're bankrupt," what will happen? The bankers will be told they have non-performing loans, the shareholders will be told they're holding worthless paper and the workers will be told they have no jobs. But if they use cash flow to pay down debt – since their business asset prices never go negative – at some point, their balance sheets will be okay again. It is a matter of time. If you have no cash flow, it's different. You have to raise a white flag and step off the stage. But if the basic business is sound, it's in the interest of all the stakeholders that the cash flow be used to gradually repair the balance sheet. In Japan, that was the action that was taken.

But the problem is – even though that is the right thing to do at the micro level – when everybody is doing it at the same time, in the macro economy you get the situation I mentioned where even at zero interest rates, everybody is paying down debt.

Do I remember a very simple example in your book showing how easily that can become poison?

It is very simple, really. Think about a national economy. When you have someone paying down debt, you'd better have someone on the other side borrowing that money and putting it back into the income stream, or else the economy will shrink like crazy. In a normal national economy, banks and securities firms act as intermediaries to channel household savings (plus debt repayments by firms) to corporate borrowers. Take, for example, a household with $1,000 of income that spends $900 and saves the remaining $100. The $900 that is spent becomes income for someone else and continues to circulate in the economy. The $100 of savings is deposited in a bank or other financial institution and eventually is lent to a business, which spends (invests) it. In this way, all of the original $1,000 in income is passed onto others. The economy remains in motion; every $1,000 income generates (at least) $1,000 in spending.

But what if there are not enough businesses eager to borrow all of the household's $100 in savings? The banks' first response would be to lower inter-



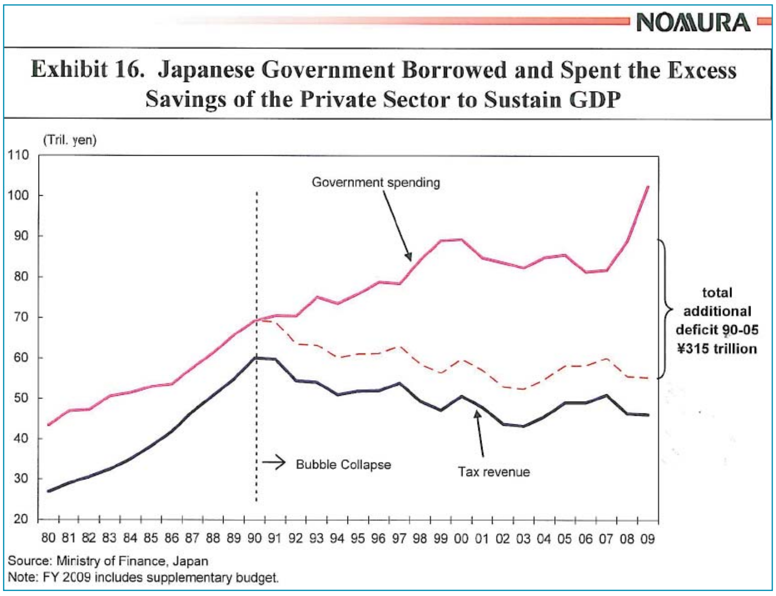


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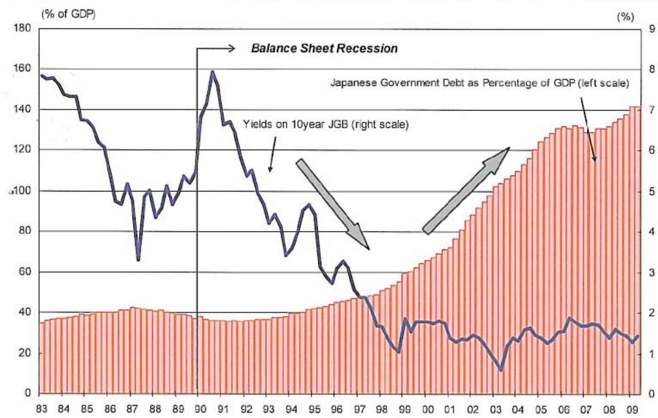
Exhibit 17. With Government Borrowing and Spending the Increase in Private Sector Savings*, Large Deficit Does Not Mean Higher Interest Rates



* Household savings plus corporate debt repayment
Sources: Cabinet Office, Japan, Japan Bond Trading Co., Japan Securities Dealers Association

est rates to attract hesitant borrowers to take out loans so that the initial household's entire $1,000 of income would be recirculated and the economy could keep firing on all cylinders. Conversely, if there were a surfeit of willing borrowers, the banks would raise rates. This is how a normally functioning economy works.

But when everybody's balance sheet is underwater, like in Japan in the early 1990s, even if you bring rates down to zero, nobody is going to borrow. Instead, companies were paying down debt at the rate of several tens of trillion yen a year. Under these conditions, to go back to our example, our hypothetical household's $100 deposit in the bank will neither be borrowed nor spent – despite the bank's best efforts. In which case, only $900 of the original $1,000 in income is spent to become income for someone else. Then assume that this next household also spends 90% of its income and saves 10%. That means it spends $810, and saves $90. Once again, the $810 becomes someone else's income, and the $90 accumulates in the banking system, because no one wants to borrow it. It gets stuck. As this process is repeated, each household's income is reduced, from $900 to $810, to $729, and so on, sending the economy into a deflationary spiral. The downturn in the economy depresses asset prices further, redoubling the urgency of companies' efforts to pay down their debt, and all of this perfectly rational behavior on a micro level leads to a disastrous fallacy of composition – the most frightening aspect of a balance sheet recession, in which firms are no longer maximizing profits, but are minimizing debts instead, so that the fundamental economic mechanism responsible for channeling savings into corporate investments ceases to function. This is exactly what happened 70 years ago in the U.S. during the Great Depression. And it's what happened during Japan's Great Recession, when falling land and equities prices, starting in 1990, wiped out wealth amounting to 1,500 trillion yen, a figure equivalent to three years of national output. As a point of comparison, the Great Depression in the U.S. cut GNP nearly in half within four years of its 1929 peak and sent nationwide unemployment as high as 25%, while share prices shrank to about an eighth of their peaks. Yet all of that carnage resulted after a loss of national wealth that is estimated at the equivalent of only *one* year's worth of 1929 GNP. So there's no doubt about the magnitude of the damage sustained by Japan in the wake of the Heisei bubble collapse. And once you understand this deleveraging process, and the devastating effect it has on the macro economy, then you can appreciate what happened in Japan during this 15-year period, and the lessons it holds for what is happening in the world today.

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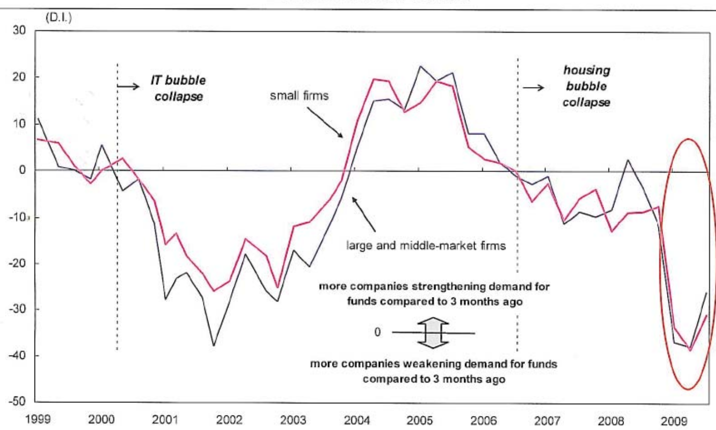
Exhibit 7. US Demand for Funds Is Falling Sharply even with Zero Interest Rates



Source: Nomura Research Institute, based on FRB, *Senior Loan Officer Opinion Survey on Bank Lending Practices*.
Note: D.I. are calculated from the answers to the question, "Apart from normal seasonal variation, how has demand for C&I loans changed over the past three months?"
D.I. = ("Substantially stronger" + "Moderately stronger"×0.5) - ("Moderately weaker"×0.5 + "Substantially weaker")

Which are?

The main one is that once we're in a balance sheet recession, as we are globally today, we will never come out of that recession until the private sector balance sheets are repaired. In the meantime, governments can do a lot of things to prop up the economies, but for the economies to stabilize and then return to self-sustaining growth, we need to have private sector balance sheets in good enough order – and that takes a while.

Is our situation in the U.S. really all that comparable to what happened in Japan?

Take a look at what has happened to U.S. house prices, using the Case-Shiller index [Exhibit 11] and what happened to Japanese house prices in Tokyo and Osaka, exactly 15 years earlier. The rate of increase and the duration of the increase, as well as the rate of decline and the duration of the decline are almost *exactly* the same. There are people out there who object that Japanese people are very different from Americans, the markets are different, this and that, but when it comes to the bubble, I'm afraid, you have acted exactly the same way. Now this chart also projects into the future, using the futures market in the U.S. for house prices, the index listed on the Chicago Mercantile Exchange, and it shows that house prices might be staying around current levels for quite a while. Which is a relatively good sign. But it also means that house prices have returned to the levels of 2002-2003, which means that all the savings that American households *thought* they had in their houses, from 2003 on, have been destroyed.

That's a staggeringly pretty penny.

Indeed. I have another chart, [Exhibit 12], which shows just how enormous the amounts involved are; how much savings American have to rebuild now. Now, there are some assumptions involved in this; obviously, if you tweak the assumptions, you can change the amounts, but I think mine are reasonable. First of all, I asked how much savings Americans would have accumulated at a 4% savings rate, because that was pretty much the prevailing savings rate in the mid-1990s, and there are Federal Reserve studies that pinpoint the beginning of the real estate bubble as being in 1997. (Up until that time there had been a very consistent relationship, for 40 years or more, between average rents and home prices, and in 1997 it started to diverge sharply.) So the white columns on the chart simply assume that the savings rate had stayed at 4%, while the orange ones show the actual savings rate, and you can see the huge gap that opened between actual and "normal" savings. Americans spent roughly $1.5 trillion that should have been saved. This is the amount they have to re-save, if you will, to get back to where they thought they were. We are already seeing the result in the skyrocketing U.S. savings rate in the most recent periods – even if the U.S. statistics were recently restated to eliminate some of the negative numbers we got used to seeing earlier this decade. (I don't know who thinks they're fooling whom.) But we're also seeing consumer debt falling sharply, which of course also means that savings are increasing. So the trend is very much with us, and I expect it to continue, not just in the U.S. but in the U.K., Ireland, Spain – all of the many places where housing bubbles have burst.

You're full of cheery news.

Sorry, but all of this is very bad news, because it means consumption will remain low, final demand will remain weak and it could actually grow weaker. Against that backdrop, even if house prices are finally starting to stabilize in this country, the bad news is that commercial property prices in this country haven't seen a

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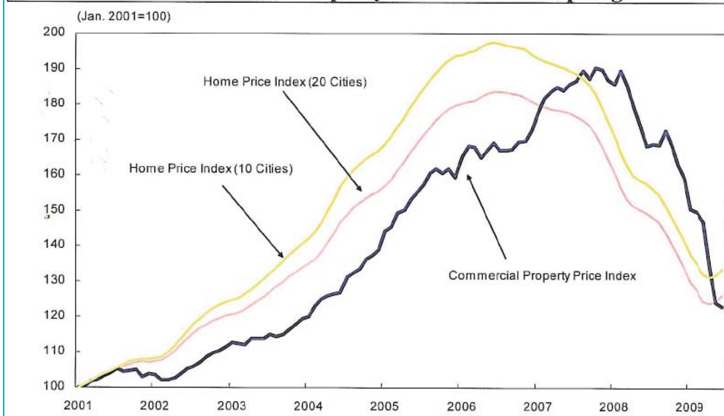
Exhibit 13. While Home Prices Are Stabilizing, Commercial Property Prices Are Collapsing



Notes: Home Price Index is from "S&P/Case-Shiller® Home Price Indices", and Commercial Property Price Index is from "Moody's/REAL Commercial Property Price Index (CPPI)".
Sources: Nomura Research Institute, based on S&P, Real Estate Analytics LLC, and Geltner & Pollakowski (2007) "A Set of Indexes for Trading Commercial Real Estate Based on the Real Capital Analytics Transaction Prices Database".

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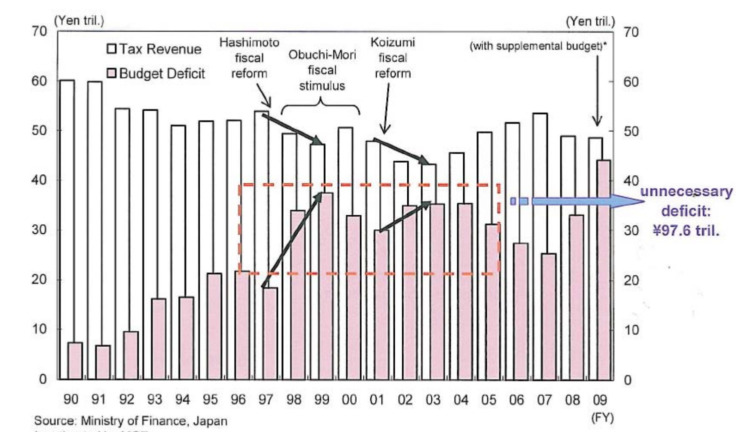
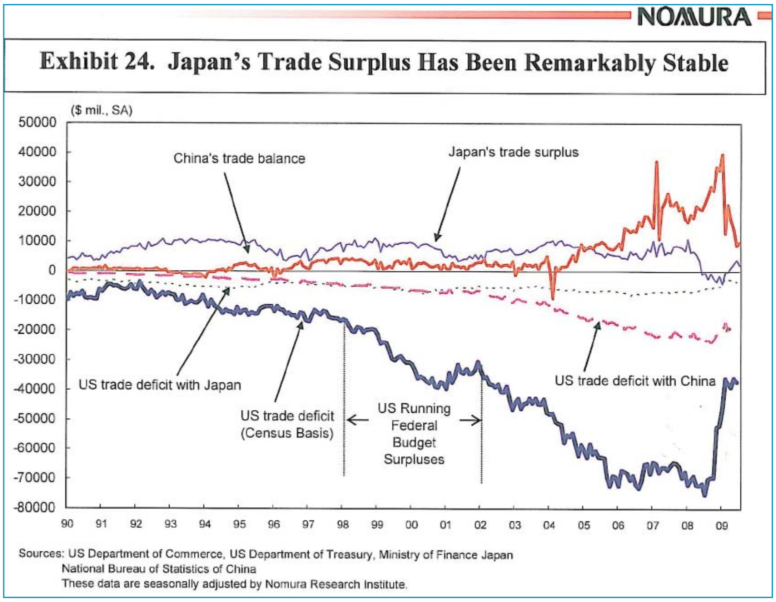
Exhibit 22. Premature Fiscal Reforms in 1997 and 2001 Weakened the Economy, Reduced Tax Revenue and Increased the Deficit



Source: Ministry of Finance, Japan
*: estimated by MOF



bottom yet. As many people are now aware, there is a time bomb involved on the commercial property side, because of refinancings of those debts that are coming due in the next year or two. If those refinancings don't go well, those properties will hit the market at distressed prices, putting even more pressure on prices. And when you look at U.S. bank assets, about half of their total exposure is to individuals, but the other half is to companies – and a large portion of that is tied to commercial real estate. We still have to be very careful about the financial sector's exposure to potential time bombs.

Yet you claim there's a ray of hope somewhere for the U.S. and all the other parts of the globe that have so recently sustained massive hits to their wealth?

Right. As my chart of Japan's GDP from 1980 through this year [Exhibit 14 on page 1] shows, Japan's GDP grew even after the massive loss of wealth it suffered when its real estate bubble burst – and after 15 years, we were finally able to come out of our balance sheet recession. That happened even though the private sector was rushing to pay down debt all during that time. And the reason is that the government's fiscal spending kept incomes growing enough that GDP *never* fell below its bubble peak, in either nominal or real terms. Of course, growth rates were low, and we had some periods of negative growth. But GDP *never* fell below the peak of the bubble.

Still, Japan's growth rate over the last decade and a half doesn't inspire much envy — anywhere.

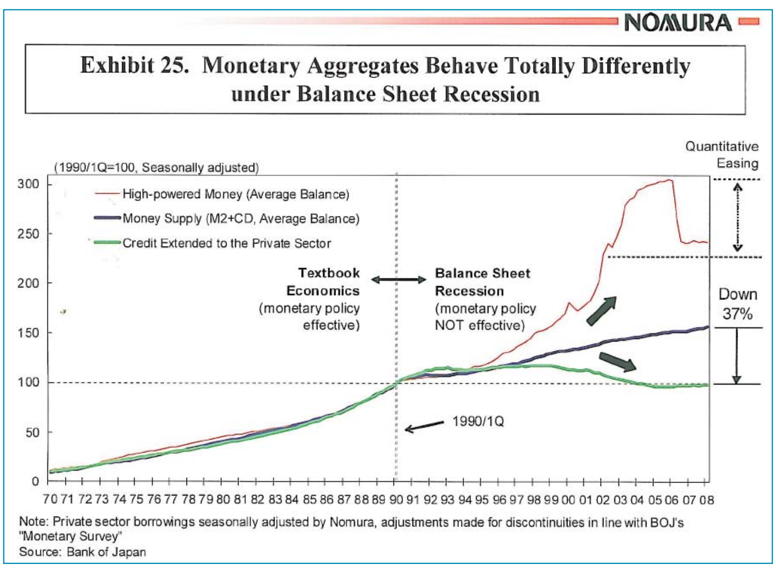
That's exactly right – until you look at what happened to the value of Japanese assets over that period [Exhibit 14, again]. I never know how much people in the West actually know about Japan in those years, because the reporting has been rather poor and spotty, I'm afraid. But the chart shows that Japanese commercial real estate assets, which had led the bubble, fell 87% from the peak in 1990. Just imagine, Manhattan real estate prices down 87%! San Francisco down 87%, Chicago, down 87%. What sort of economy would that create here? In Japan, our commercial real estate prices fell back to the level of 1973 – and we *still* managed to keep our GDP from falling. I think that was a pretty spectacular achievement. The amount of wealth we lost [Exhibit 15], just in real estate and equity assets, was 15 trillion yen, or 3 years of GDP – which is equivalent to a $45 trillion loss in the U.S. The largest loss of wealth in human history, in peace time.

Quite a shock to the system, I'm sure.

So how did we manage to keep GDP from falling, despite the double whammy of this massive negative wealth effect and everyone in the private economy trying to pay down debt at once?

***You* tell me—**

Well, we happened to have the Liberal Democrats, who just lost the recent election, in power throughout this period, and they were highly liberal with public spending. So the Japanese government borrowed and spent the excess savings of the private sector to sustain GDP [Exhibit 16]. It wasn't a smooth process,



because – especially when it started – no one realized what we were dealing with. As soon as the economy started to weaken, these politicians said, "Hey, let's build roads and bridges"-- thinking that this was a *temporary* decline in economic activity and that with liberal pump priming, we should be fine. Just like last year Larry Summers was saying the U.S. has to do *temporary* pump priming. Japan's leaders were saying the same thing in 1992-'93. So they put in fiscal stimulus – and the economy improved.

Just like that?

Sure, because what is fiscal stimulus? To go back to my earlier simple example: The government borrows that $100 that is stuck in the banking system and spends it on public projects. Now it's back in the income stream, so the entire original $1,000 is recirculating in the economy again and there is no reason for GDP to fall. But *because it worked*, what happened? The government withdrew the stimulus, and the economy faltered again, because the private sector was still paying down debt, instead of borrowing, and that $100 got stuck in the banking system again. So Japan had to start another stimulus program, and another. Exhibit 16 also shows government spending over the entire period, against tax revenues, so the gap is the fiscal deficit. The dotted line indicates what I call the structural deficit, the little bit of a deficit we had even before the bubble burst. Anyway, what my work shows is that the total additional, or cyclical, deficit that the government created to sustain GDP during Japan's balance sheet recession amounted to 315 trillion yen, which took the fiscal deficit to about 63% of GDP. But I would argue that this 63% of GDP deficit represents the most successful fiscal stimulus in history.

How do you figure?

Think about it. If the LDP hadn't engaged in all that deficit spending, what would have happened to Japanese GDP? Chances are high that instead of growing ever so slowly, it would have come down just like real estate values did. Remember, the amount of wealth the U.S. lost in the Great Depression is estimated to have equalled one year of 1929 GDP. Japan lost wealth equivalent to *three* years of 1989 GDP. So Japan should have experienced a GDP decline far larger than 46% drop the U.S. suffered in the 1930s. Even if we conservatively estimate that Japan's GDP would only have fallen back to the level of 1985, which was when the bubble began, the difference between that and what Japan actually achieved, over the 15 years between 1990 and 2005, would have amounted to over 2,000 trillion yen. In other words, to my way of thinking, the government bought GDP equivalent to 2,000 trillion yen with 315 trillion yen of deficit spending. A very good bargain, I'd say.

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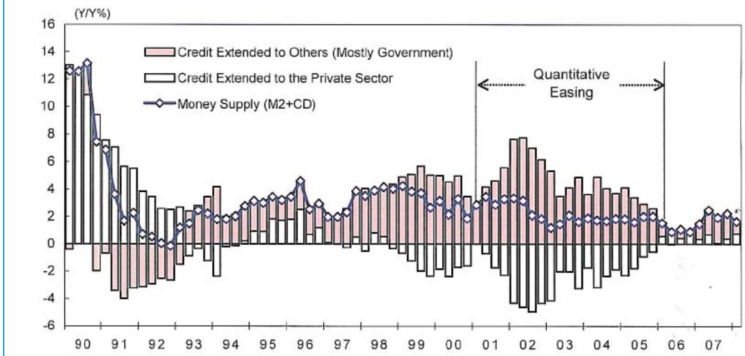
Exhibit 26. Japan's Money Supply Has Been Kept Up by Government Borrowings (I)



Sources: Bank of Japan "Monetary Survey", "Changes in Money Stock (M2+CD), and Credit Statistics"
Notes: "Credit extended to others"= (1) public sector + (2) foreign assets (net) + (3) others.
(1) Public Sector = credit to the government (net) + credit to regional public sector bodies + credit to public corporations
(3) Others= (money + quasi-money + CD) - (foreign assets (net) + domestic credit).
Therefore, increase or decrease in "Credit extended to others" will include impact of increase/decrease in public sector debt, increase/decrease in bank debentures issued by private sector banks and deposits of financial institutions, and errors in data.

It's fair to say a lot of folks disagree, especially now that the LDP lost the election.

A very negative opinion of Japanese fiscal stimulus is common, especially in the U.S., where the assumption of most critics is that, even if we had done nothing, we would have had 0% growth. Since Japan's actual growth over those years was quite modest, we must have wasted

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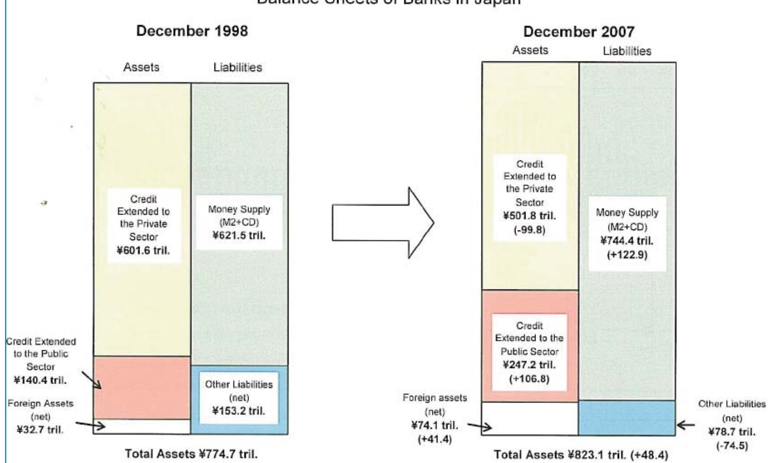
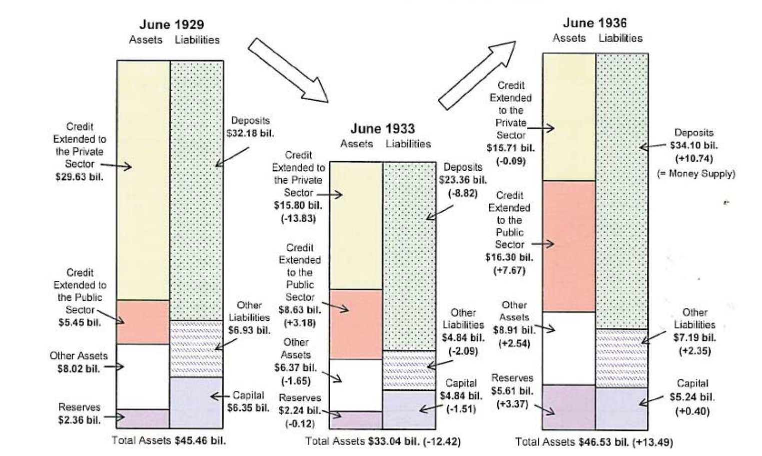
Exhibit 27. Japan's Money Supply Has Been Kept Up by Government Borrowings (II)

Balance Sheets of Banks in Japan



Source: Bank of Japan "Monetary Survey"

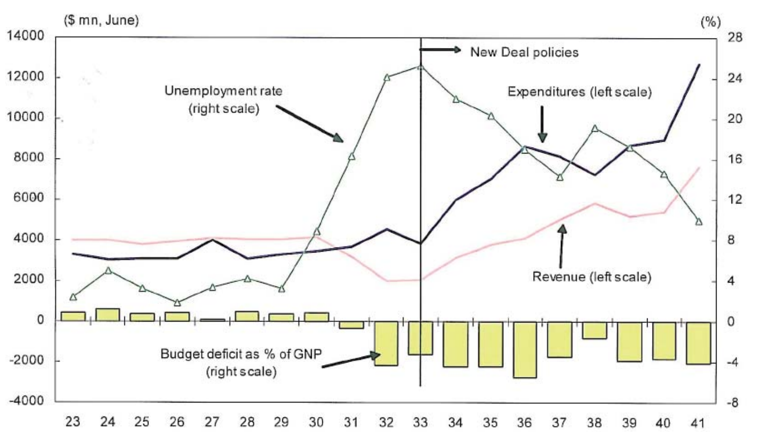
Exhibit 28. US Money Supply Growth after 1933 Was also Made Possible by Government Borrowings



Source: Board of Governors of the Federal Reserve System (1976) *Banking and Monetary Statistics 1914-1941* pp.72-79

most of that stimulus on useless projects, bridges to nowhere. The LDP must have been awful stewards of the public treasury. But that basic assumption is just plain wrong. Once you understand that we lost wealth equivalent to three years of GDP, you have to realize that growth wouldn't have stayed flat-to-up, without the stimulus. So the lesson to be learned is that no matter how huge the asset price collapse may be, if the government takes meaningful stimulative action from the very beginning and continues it throughout the period when balance sheets are being repaired, there is *no* reason for GDP to fall. That is what Japan has proven. The U.S. and Germany didn't recover from the Great Depression until World War II. Japan is the only country that has managed to keep growing and emerge from a balance sheet recession without fighting a war.

Exhibit 29. New Deal Policies Doubled Fiscal Expenditures without Increasing Budget Deficit



Source: Board of Governors of the Federal Reserve System (1976), Vol. 1, p. 513; US Bureau of the Census (1975), p. 229.

But what about objections that Japan's experience doesn't apply to the U.S. here and now, because Japan didn't enter its Great Recession as the world's largest debtor nation?

I hear that all the time. But the other thing the Japanese experience proves is that, in a balance sheet recession, when there is no demand for borrowing from the private sector, government borrowing for fiscal stimulus does *not* drive up interest rates. Japanese government bond rates fell to microscopic levels over this period, and stayed there [Exhibit 17]. When these points are understood by policymakers globally, then people should feel a lot better, even with asset prices collapsing, because it *is* possible to keep GDP from falling, meaning that national income can be maintained, and – as long as people can continue to pay down debt – this problem will be over at some point.

Maybe. But with its massive store of savings, Japan didn't have to worry about depending on the kindness of creditors in China and the Mideast as its bond rates scraped along at zero. The U.S. does.

The truth is that Japan was actually in that same precarious position, a decade ago. With Japanese government debt skyrocketing because of massive fiscal deficits, all of the ratings agencies, the IMF, the OECD – they all issued horrendous warnings against Japan. Japanese bond investors remember very well that JGBs were downgraded repeatedly, to the point where Japan's debt was rated lower than that of *Botswana*, because the ratings agencies were so sure that at some point the whole thing would come crashing down and that interest rates would soar. But it never happened. And the reason is easy to understand, once you grasp the concept of a balance sheet recession. The amount of money that the government has to borrow and spend to sustain GDP is *exactly equal* to the amount of excess savings generated within the private sector of the economy. So that money is actually available *within* the private sector, even in the U.S., even in the U.K. And the U.S. is no longer a low savings rate country; the last statistic was over 6%, higher than Japan. What's more, with companies also increasing their savings, there's no "crowding out" and banks are only too happy to lend to the government, as the last borrower standing – and also because they don't have to keep as much capital against loans to the government as they would against private sector loans, allowing the banks to rebuild their profits and balance sheets.

It sounds almost too good to be true —
It's not. I believe that as more and more people in the U.S. realize that this is the mechanism at work, the fear of interest rates rising will be increasingly reduced, and I won't be surprised to see long bond rates in the U.S. falling from where they are now. In any event, whether you start with a high savings rate or a low savings rate, once a country enters a balance sheet recession because the private sector is paying down debts, you end up having excess savings in the private sector and it is those excess savings that the government has to borrow and spend. It doesn't have to borrow externally. So the U.S. doesn't have to borrow from China or anywhere else. But because that's contrary to the mind set for the last 10 or 20 years, it's very hard for people to come around to that realization.

You spend quite a few pages of your book discussing why so many economists haven't seen what you see —
Well, I think it is because so-called neo-classical economics starts from the very premise that the private sector is maximizing profits and everything is built off that premise. Besides, it was also a question of what data they have been looking at. For most of the post-war period, people *were* maximizing profits in the West, so no one had to look for other possibilities. But during the Depression, and in the 1990s in Japan, the private sector was actually minimizing debt, not maximizing profits. As I wrote, people minimizing debt are never anxious to advertise that they're effectively bankrupt. As a result, the true nature of a balance sheet recession was invisible, inaudible. Companies working to minimize debt are the least likely to share that fact with the outside world.

Disclosure standards vary, I'll grant you. Still, any reasonably competent analyst should be able to recognize a deteriorating balance sheet — no matter how unfashionable it is to read the things.
Yes, on the liability side, debt levels are easy to check because there are counterparties, the bankers, the bond market. So it's hard to play with those numbers. But we all know, from the **Enron** case and many others, that it's fairly difficult for people on the outside to know how each and every asset held by a company should actually be valued. Doing it right could require independent appraisals of things like real estate assets as frequently as every 3-6 months. No one is going to do that. So valuing the asset side is where some funny things can actually happen, whether in Japan, or anywhere in the world. I mean, in the current circumstances, how do you value CDOs, when the market doesn't exist anymore?
But your question about economists reminds me that I never finished my point about Larry Summers.

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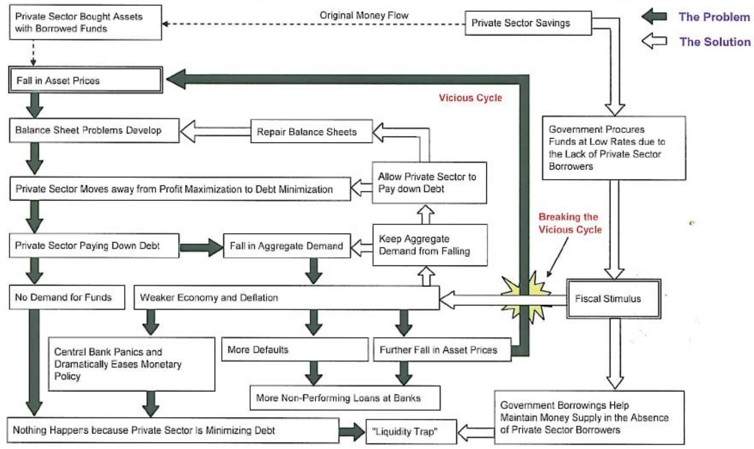
Exhibit 32. The Anatomy of Balance Sheet Recession and Its Cure



urce: Richard Koo, *Balance Sheet Recession: Japan's Struggle with Uncharted Economics and its Global Implications*, John Wiley & Sons, Singapore 2003

You called his focus until recently on making sure that fiscal stimulus is temporary worrisome —
Yes, but then he basically admitted in July that what the U.S. is facing is "qualitatively equal" to what Japan faced in the 1990s. So instead of the three T's he used to push, now he's arguing that the U.S. needs three S's. Which stand for speedy, sustainable and substantial. The U.S. needs speedy fiscal stimulus, substantial fiscal stimulus, and the fiscal stimulus has to be sustained. That's a very big change from temporary, targeted, and timely.

Are you suggesting he went back and reread your book?
It surely sounds like it. I don't want to claim credit, but at least he has it right now. The U.S. does need those three S's, and the fact that Larry started talking like that suggests to me that President Obama actually won't try to cut the budget deficit in half in four years' time. Which is a big relief to me, because I think the

biggest danger the world economy is facing is that the U.S. shifts gears into reverse in two years, when its private sector is still in balance sheet repair mode.

You're walking into a political hornets' nest in this country. The GOP would love nothing better than to paint the Obama team as profligate spenders destroying our children's future with deficit spending.

Yes, that is going to be an enormous political challenge and I don't underestimate the danger or the difficulties involved because I went through the same process in Japan for a full 15 years; trying to explain to people that if you don't do it, the situation will be far worse. And the more successful you are in preventing the crisis, the less appreciative the people will be of your efforts. As a general in Japan's self-defense force taught me, if you continually prevent crises, you will never become a hero. Look what just happened to the LDP. I think that's true in the U.S. as well. Obama's $787 billion rescue package seems to be working; the economy seems to be recovering. The temptation for the blue dog Democrats and for the Republicans to cut the budget deficit, now that the stimulus seems to be doing its job, will be tremendous. It will be very difficult for a Larry Summers or a **Tim Geithner** to come out and say, "No, we cannot cut the budget deficit now because the private sector is paying down debt."

We "can't handle the truth," you mean?

Well, first of all, except for my book, there is nothing in economic literature to suggest that a government should keep spending money even after an economy starts showing signs of life. Conventional wisdom would suggest that with the economy improving, the pump priming worked, so fiscal stimulus is no longer needed.

As a matter of fact, economic orthodoxy says government borrowing should be pulled back so that it doesn't crowd out the private sector —

Right. That's the conventional wisdom, but that *assumes* that private sector demand for investment is there. *If it is*, *if* the private sector wants to borrow, *if* the U.S. savings rate is coming down again, *if* companies are increasing their leverage, by all means, cut the public budget deficit. But we don't see any of those signs. And if the government tries to deleverage before we see the private sector finish its own deleveraging, then I think the whole thing will come crashing down just like in 1937 in the United States and 1997 in Japan.

But politically, I'm very aware that this all is very tricky. Japan's LDP just was driven from office, in part because people didn't understand that all of its much-criticized "bridges to nowhere" at least prevented a complete meltdown in the country's economy, despite an 87% decline in commercial property values. We managed to keep GDP from falling despite losing wealth equivalent to three years of GDP. The problem is that people's frame of reference was wrong. You have to compare where Japan is *to what might have happened in the absence of fiscal stimulus.* But because people have never experienced that themselves, the argument has to be made very clearly or they won't appreciate what fiscal spending accomplishes. I have noticed that President Obama habitually mentions that "without these actions the recession would have been much worse." He always adds that little phrase when he talks about economic policy actions and that's the right thing to do – as far as it goes.

But?

I'd much prefer it if he came out and *explained* what kind of disease the U.S. has, so that people would better appreciate what might have happened in the absence of the those actions. To my knowledge, he hasn't come out and said that this is a balance sheet recession, a different disease, yet. Larry Summers saying this is qualitatively similar to what Japan had is the closest anyone in the Administration has come, and Larry didn't go any further than that one phrase. Which isn't enough, I don't think, to convince the American people that a different treatment – sustained, speedy and substantial deficit spending – is needed this time.

An extraordinarily tall order, for a nation in hock up to its eyeballs to foreign rivals.

If you're going to be ruled by conventional wisdom, yes. But didn't I just note that the U.S. savings rate is already skyrocketing, even with interest rates near zero? Doesn't that say something is different this time? Didn't we say, too, that the Fed's loan officer survey continues to indicate very weak demand for loans from the private sector? So both individuals and companies are generating savings, which are being trapped in the banking sector, because there are no borrowers. Which means there's plenty of money available, *inside the U.S.*, for the government to borrow and spend to stimulate the economy. The United States does not need the Fed, the Chinese, or Japanese, or Arabs to buy

U.S. Treasury bonds. To repeat: The amount of money that the U.S. government has to borrow and spend to keep the GDP from falling is exactly equal to the excess savings in the private sector in the United States. And it will be able to borrow that at ridiculously low rates. After all, even with all the talk of green shoots and the stock market rallying, the long bond yield in the U.S. is still in the 3% range. Long bond, meaning 10 years. How can that be with a huge and growing fiscal deficit? Precisely because people cannot find other places to put their money. The entire private sector is deleveraging. Again, as I said, we, in Japan, actually went through exactly the same debate 10 years ago. Everyone said we were headed for absolute disaster because our budget deficit was skyrocketing and interest rates were sure to follow. Instead, the JGB yield kept on going down and has stayed the lowest in human history for the last 10 years. Right now it's about 1.4% on a 10-year. During the Great Depression in the United States, the lowest yield was 1.85% on a 10-year government. We are at 1.4% because everybody is saving, no one is borrowing.

And you see U.S. yields following suit?
Now I don't think U.S. bond yields will go to 1.4%, but if they go into the 2% range, I won't be surprised at all.

But what about the buck? You're unconcerned that China might get fed up with watching us pile on more debt?
My concern is actually the opposite. Not only because the deficits are entirely financeable *inside* the United States, but also because China is doing exactly the same thing. China is running a huge fiscal stimulus program, 17% of GDP over two-year period, bigger than anyone else has ever seen in peace time. The Chinese, who actually *read* my book, translated my book into Chinese (though I didn't make a dime on the deal), have invited me to Beijing on many occasions to explain how Japan managed to keep its GDP from falling after its bubble popped.

What makes the Chinese such Koo groupies?
The current crop of Chinese leaders lack revolutionary credentials, they've repudiated Communism and certainly aren't popularly elected. The legitimacy of the entire regime is based on increasing the nation's living standards. Charismatic, this crew isn't. But they understand very well that they have to keep the economy moving forward. They've seen what has happened elsewhere, and they've been very concerned with what happens when asset bubbles break. That's why they've read my book. Now they know *exactly* what to do; they are using the Japanese lessons to the *fullest*. Of course, they don't have any political opposition to worry about, which is one huge plus for them – as long as they are doing the right things. So they were the first ones to come out with a massive fiscal stimulus package, 17 trillion Yuan, during this crisis. That was last November, just three or four days before the G-20 meeting.

I've seen a lot of speculation to the effect that China's big stimulus number was just for show; that the actual amount of fresh spending ordered up wasn't nearly as huge as it seemed.
On the contrary, there are indications the package is actually bigger than the numbers cited, because many local governments are adding their own money to the effort. What the Chinese understand is that during a balance sheet recession, you must have fiscal stimulus or the whole economy will collapse. So they actually are *not* opposed to the United States running a large budget deficit. They're actually happy that the U.S. is doing the right thing there. What the Chinese are *not* very happy about is **Ben Bernanke**'s monetary policy.

Quantitative easing isn't China's thing?
Monetary policy in a balance sheet recession doesn't do much good – as we found out in Japan, and as zero interest rates in the United States are demonstrating right now. But Mr. Bernanke, who long has been a student of the late Milton Friedman, has been arguing that monetary policy can solve almost all problems for the last 30 years. So for him, the idea that zero interest rates cannot cure America's ills is unacceptable. That's why he has gone to so-called unconventional monetary policy, buying distressed assets from the private sector and so forth, expanding the Fed's balance sheet very aggressively. And *that* worries the Chinese *immensely,* because today's currencies are not backed by gold or silver, right? They're backed simply by the peoples' trust in their central banks. So what happens if average Americans – or anyone else – starts saying that the Fed's balance sheet looks worse than Citibank's?

Heaven forbid.
But suppose people get worried that Maiden Lane I, Maiden Lane II, Maiden Lane III, all those funds run by the New York Fed, are actually under water? What will that mean to the

dollar? We have no idea. But what the Chinese are worried about is the value of the dollar. And I can tell you that it is not just the Chinese who are worried. All the investors around the world who hold large amounts of dollar assets are worried – about Bernanke, not about the U.S. deficit. Because as long as the central bank stays put; acts only in ways that are worthy of peoples' trust, the budget deficit, per se, does not have to bring dollar exchange rates down. But if the central bank takes some crazy unconventional monetary policy action, like buying distressed assets from the private sector, *then* we won't know what's going to happen next. That is why people are worried. And it is why Mr. Bernanke announcing recently that they are not buying any more U.S. Treasury bonds was also a positive, as far as the Chinese are concerned. What the Chinese, and many Japanese, want to see is U.S. monetary policy standing firm. They don't want to see the Fed monetizing the debt. They don't want to have to worry that, ohmygosh, Bernanke is going to flood the economy with dollars so either inflation or a dollar collapse might be just around the corner. Now, those kinds of worries, as I said earlier, I think are misplaced, because even if Bernanke did buy T-bonds, U.S. bond yields would eventually come down and higher inflation isn't in the cards. Nonetheless, when you see the Fed monetizing debt, people have a right to worry about inflation. That worry alone could even push inflation higher and discourage the fiscal authorities, like **Tim Geithner**, from adding to the fiscal stimulus when it's needed. Then you would end up having the perverse effect that monetary policy, which is basically useless in a balance sheet recession, nonetheless scares people off, and pushes rates higher. In other words, it could discourage using the only medicine that works, meaning fiscal policy, to treat the balance sheet recession disease.

You're saying the central bank chief should sit on his hands? Good luck.
Well, if I were in Mr. Bernanke's position, I would come out and say, "We did everything we can do. What still needs to be done is on the fiscal side and we, at the central bank, are happy to help the fiscal authorities, if and when our help is needed." But I would also add that the fiscal authorities, except in some crazy circumstances, should not need help from the central bank. The excess savings they need to fund fiscal deficits are available in the domestic private sector, and the stimulus programs they go into should be medium-term, seamless, and centered on government spending, not tax cuts, for the entire duration of the balance sheet recession.

Why not tax cuts? Politicians love tax cuts.
I like to have tax cuts myself. But from a macroeconomic perspective, when the private sector is minimizing debt because of a balance sheet problem, if you give them a tax cut, they'll be more than happy to use that tax cut to pay down their debt or rebuild the savings that they have ignored for so long. But they're unlikely to spend it. If you remember George Bush's tax cut of last summer –

That's exactly what happened to it.
Yes. Something like 88% of the rebate checks were used to pay down debt or rebuild savings. Only 12% went into new consumption. So I would argue that tax cuts under the current circumstances are the most inefficient way to expand the economy for the given amount of budget deficit.

Yet conservative economists like to cite the work of a number of econometricians to claim that the multiplier on tax cuts is far higher than on deficit spending.
The trouble with most of that econometric work is that it uses data collected exclusively in the post-WWII era. Because not much data was collected during the Depression, their studies generally don't go back that far. But the U.S. hasn't had a balance sheet recession since the Great Depression. That means that their data only reflects an ordinary textbook world, and whatever econometric models you derive from it, won't apply to world Americans live in *now*, because they are *not* maximizing profits. They are minimizing debts, which is definitely not what the textbooks say. The same sort of problem also surfaced in the "stress tests" of U.S. banks.

How so?
They said they used a lot of econometrics to see what might happen under worst-case scenarios. But how do you use econometric studies when U.S. house prices, in aggregate, never fell during the last 70 years? You don't have a data set for a world in which house prices are collapsing. That alone should make you question those econometric results.

Let me ask this: You keep stressing that the government's deficit spending has to be sustained for the duration of a balance sheet recession, but wouldn't it be more prudent for policymakers to only approve

it in small doses, to avoid overdoing it?
No, because of the political difficulty in trying to maintain fiscal stimulus when an economy is showing signs of life. Not just in the U.S. or Japan. When I was invited to speak to the Dutch government, they told me exactly the same thing. It's especially fraught in Europe, where the Maastricht Treaty limits the fiscal deficits to a maximum of 3% of GDP. When those economies begin to show signs of life (because all of the European economies are putting in fiscal stimulus), the temptation to cut fiscal spending to reduce the budget deficits will be tremendous. And there will be a legal basis to push that argument because of the Maastricht Treaty. So some of the ministers and top bureaucrats that I talked to were very, very pessimistic. Afraid that they are destined to have a second dip because they will have to cut the stimulus too early. It really is a global problem at this point – except in China, where they don't worry about an opposition, because there is none.

Isn't the downside, though, that without the checks and balances provided by either a "loyal opposition" or a market economy, China's fiscal stimulus can be quite wasteful?
Well, the Chinese have become aware of that, so in the last few weeks they have started issuing warnings to their banks to be more careful with their lending, which I think is good. But when I talk to the Chinese officials, they put it this way, when they are warned about new bubbles potentially brewing in China: "Well, it could happen. But we are more worried about our current problems first." I think that's the right attitude. If you want to keep the economy from collapsing totally, even if there is a possibility that, in the process, you ignite a small bubble somewhere, that's a risk you're willing to take. That way you win time to do other things. Besides, China needs such a huge amount of infrastructure that even though some of the stimulus they're putting into the economy now may end up, in retrospect, looking wasteful, most of it is likely to prove worthwhile. In fact, a lot of China's stimulus projects are very much required.

I can just hear hardcore conservative economic types complaining that your focus on deficit spending "buying time" while balance sheets are repaired is precisely the wrong thing to do. If the private sector is overburdened with debt, they argue for an Austrian solution in which the insolvent fail and allow the survivors to emerge stronger.
Well, that view was the view of **Andrew Mellon**, who was Treasury Secretary under **Herbert Hoover**. So that experiment was tried from 1929 to 1933 and almost half of U.S. GDP disappeared. Unemployment rate went to 25% and bringing the economy back to full employment literally took the Japanese attack on Pearl Harbor. I don't think that's the way we want the world to come back to life. People who argue that zombie companies should be allowed to go to hell so that the remaining companies will do much better afterwards, don't realize that, first of all, zombie companies with no cash flow cannot pay down debt, and if they cannot pay down debt, they actually are *not* the source of the problem in a balance sheet recession. Balance sheet recessions are caused by good companies with good cash flow paying down debt. No one would suggest that good companies using their cash flow to pay down debt should be pushed into bankruptcy. That's one point. My other point is that the hardcore, let-them-fail, conservative view assumes that bad companies are a small minority and that good companies are the majority. As long as there are sufficiently large numbers of good companies around to pick up the pieces, then by all means, it's okay to let bad companies hit the wall. But if the ratios are reversed, so that most entities in the private sector have balance sheet problems, and only a few are good, and you tell that the majority of bad companies to go to hell, the few remaining good ones would probably go down the drain with them, because there would be no income. Everybody would be in such a bad shape, poverty, that they won't be able to revive the economy at all. If you have a banking crisis, for instance, where a majority of financial institutions are having the same problem, then you *have* to go slowly. The option of going fast does not exist because there won't be any buyers of assets left. But if the banks having problems or the companies having problems are the minority, and the majority is still good, then by all means, push the button. Let the chips fall where they may because there will be buyers of those assets and the economy can move forward. The conservative agenda that you talked about is implicitly assuming that the majority are okay.

You've clearly heard all of these arguments many times before—
As I said, I've grown quite used to having my views trashed.

How long have you been at Nomura now?
Twenty-five years. I actually qualify for a Japanese pension. I can't believe that I've worked here for so long. But it has been fascinating, having a U.S. background and coming to Japan to see the bubble, see it burst and seeing the aftermath has been a very interesting experience. At first I tried to explain what was happening in Japan using conventional tools. But more and more I realized that you can't. Especially when, even with zero interest rates and a zero inflation rate, I saw Japanese companies paying down debt – and not just for a year or two under some sort of a crisis, but for a full 10 years. Doing so even though bankers actually were willing lenders except for a very limited time, between October, 1997, to March of 1999.

So that forced you to get creative?
Well, after much soul searching, I came up with the idea that maybe their balance sheets were under water. Then I started asking Japanese corporate executives, isn't that the real cause? And finally, people start admitting that was actually the case– even if not in so many words.

What do you mean?
Those acknowledgements mostly came through the corporate executives' body language, not out of their mouths.

Interesting. Was your international background a help or a hindrance in figuring all this out?
Well, I was actually born in Japan to Taiwanese parents and went to a Japanese elementary school, so my first language, mother tongue, is Japanese. When I was 13, my mother decided to immigrate to the United States with my brother and me. The three of us moved from Tokyo to San Francisco. My English was nonexistent at that time and I suffered greatly for it, for many years. But eventually I went to Johns Hopkins and ended up with the New York Fed. When I got Nomura's offer, back in 1984, I had no intention of leaving the Fed because I liked the job. But the offer was for a two-year, non-renewable contract, after which I was supposed to return to the Fed, which had a program that actually encouraged staff to work elsewhere for a few years. And when I talked to my boss, he pointed out that I'd learn about Japanese markets and financial institutions, which were then just becoming active in the U.S., and that such knowledge would be useful to the Fed, down the road. So I left all my stuff with friends in New Jersey, and traveled to Tokyo, for two years – and the rest is history.

I guess that contract was renewable after all.
They found me rather useful, and I also found that if I sat in Nomura, a Japanese institution, I could find out lots of things about Japanese accounting rule changes, Ministry of Finance directives, moral suasion, etc. All sorts of things I had been trying to get a grasp of while at the NY Fed, because, as you might recall, in the mid-1980s, Japanese investors were all the rage in Wall Street.

Japanese business was going to takeover the world.
At the NY Fed, as a Japanese speaker, I'd been trying to gather information on those guys. But Japanese banks and the insurance companies, even though they had a sizeable presence in New York, didn't make decisions in there. The decisions were all made in Tokyo. So sitting in Nomura in Tokyo, I was able to find out *why* they make those decisions and I was relaying that information back to the NY Fed, making the Fed people think I should stay in Tokyo, so they could find out more. So, by mutual agreement I suppose, I ended up here for 25 years.

Where does Japan go from here? You say its balance sheet recession ended back in 2005, but it's still not exactly growing like gangbusters.
As one of my charts indicates, the private sector's debt repayment stopped in 2005. That was when people started looking forward again. But after 10 years of debt repayment, the Japanese are so sick of debt that they just refuse to borrow money, even though their balance sheets are clean, even though interest rates are almost zero. That's exactly what happened to Americans after the Great Depression. Most Americans who went through that terrible experience refused to borrow money *for the rest of their lives*, and we have the same problem here in Japan. Those companies who finally have repaired their balance sheets are saying never again. As a result, last year we were trying to put together a package to dangle a huge carrot in front of Japanese companies to give them courage to get over their debt trauma. Prime Minister **Taro Aso**, who I advised for the last 10 years, fully understands the balance sheet recession concept. He had been a businessman himself. But just as we were working on it, **Lehman Brothers** collapsed and global demand collapsed. So then we went into fire fighting mode, instead of trying to overcome

the debt trauma, because once demand is collapsing all around the world, who is going to borrow money to invest in more capacity? Now we have to do our own domestic stimulus measures, again. But our underlying problem remains how to get debt-traumatized executives to borrow again. And now we have the added uncertainty of a new government.

Thanks much, Richard.