Outside the Box

Opinion: The U.S. could catch Japan’s economic malaise if the Fed and other officials don’t heed the warnings

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Note the striking parallels between the U.S. of today and Japan before it entered its lost decades

U.S. President Joe Biden and Treasury Secretary Janet Yellen on Jan. 29. GETTY IMAGES

NIK +0.19% SPX +0.14% DJIA -0.00%

As we haltingly crawl our way out of the current global COVID-19 pandemic thrust upon us by a biological disease, it is important that the U.S. does not succumb to another affliction that could have longer-term implications for our economy.

Aging demographics, a bloated central bank balance sheet, surging debt burdens, disappointing wage and productivity growth as well as stagnating economic growth have been the Japanese economic story for multiple decades now. It is vital that our policy makers take the necessary steps to prevent economic lethargy from becoming embedded in our system, as striking parallels continue to express themselves on a variety of issues between the two countries.

First and foremost, this should mean rejecting the “financial repression” model embraced by the Japanese monetary and fiscal authorities, characterized by negative interest rates, high levels of government spending and debt, aggressive central bank ownership of financial assets, and a tax and regulatory regime that discourages innovation and entrepreneurship.

In the midst of its third lost decade, this approach has undermined the country’s previous growth-glorious profile and resulted in chronic stagnation. Since 1990, Japan has witnessed a negative compounded annual growth rate of industrial production. Public debt as a percentage of GDP now sits at 235% compared with 64% in 1990 and 50% in 1980. The Nikkei 225 Index **NIK**, +0.19%, the country’s stock market benchmark, has still not recaptured its high reached in 1989 and has generated a negative annual return over the past 30 years.

The initial culprit of these lost decades was a deflationary monetary mistake, which included a major contraction in money growth, in order to prick what was perceived as a financial bubble. Subsequently, the story has evolved into an obsessive reliance on the creation of debt and government spending, along with a variety of hyper-activist monetary actions. These include the aggressive purchases by the Bank of Japan of government bonds, exchange-traded funds, and real estate investment trusts.

This has proven to be a recipe for a perverse set of incentives that has undermined Japan’s growth and prosperity. This includes large swaths of Japanese companies having access to capital that would have been denied in a merit-based, market-oriented system, as a collaborative effort between the government, banks and monetary authorities keeps these companies on chronic life support.

While this might provide a mirage of stability, the longer-term implications of these “zombie companies” are detrimental for economic efficiency and vibrancy. It also demonstrates how ambitious Keynesian spending programs, with their supposed multiplier effects in tow, habitually fail.

Our policy makers, particularly on the fiscal and monetary fronts, need to heed the warning emanating from Japan, Inc., sooner rather than later. Their model is antithetical to the core principles that have resulted in magnificent periods of economic prosperity in the U.S. and provided rising standards of living. This growth model, when at its best, is characterized by high levels of innovation, capital formation, new business startups and robust productivity growth.

Of particular concern on this front has been the rapid emergence of Modern Monetary Theory (MMT)

as a legitimate methodology in some circles to conduct policy. It represents a direct refutation of Milton Friedman's famous dictum that there is no such thing as a free lunch.

In reality, it is more of a political philosophy, as opposed to an economic theory, and has the potential to create an "iron triangle" that could jeopardize our fiscal well-being. This would consist of Congress aggressively appropriating funds via legislation, Treasury Department authorities ready and willing to finance this spending, and Federal Reserve officials poised to monetize the newly minted Treasury debt with their magic checkbook.

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With the U.S. national debt recently exceeding the total value of the GDP, this could prove catastrophic to our national balance sheet, not to mention the potential for hyperinflation, which has historical precedent when aggressive money printing has been utilized.

It would be far better for the Fed to embrace a rules-based policy approach, such as a nominal GDP target or price rule, and ensure that the process doesn't become politicized. Encouragingly, it appears that our monetary authorities could be headed in this direction after an exhaustive strategic policy review.

A powerful first step was codified at the recent Jackson Hole Symposium, where Chairman Jerome Powell officially extinguished the Phillips Curve, a relic of a concept stating that inflation and unemployment have an inverse relationship, as a viable theory.

This is a monumental development, as the idea that a robust job market and low inflation can't coexist peacefully has been refuted time and time again over the last several decades. This novel approach should elongate future business cycles with the days of robust growth triggering an activist, inflation-fearing Fed on the wane. This could be relevant later this year as a post-pandemic mini-boomlet is likely to materialize

In unison with a rules-based Fed, and unlike Japan, it is time for our fiscal authorities to aggressively

embrace a growth agenda that would make all Americans better off and also reduce our national debt as a share of the economy. A rediscovery of 19th century French economist Jean-Baptiste Say and "Say's Law" would be a good first step. It emphasizes the income generated by the production side of the economy, of both goods and services, as a necessary precursor for consumption.

The objective should be not to merely redistribute current wealth through government spending, but to create wealth through incentive-oriented policies. This would include lower tax rates and higher after-tax rewards on income and capital, which would increase incentives for work, risk-taking and investment, thus raising output, employment and production.

While the ultimate goal should be a consumption tax that exempts savings and investment from taxation, a vastly simplified tax code with lower marginal rates would be a good place to start. This would broaden the tax base and enhance economic efficiency by reducing distortions that can be created by excessive amounts of tax credits and deductions.

Historically, a vibrant supply-side of the economy along with sound money and relatively low taxes has proven to be a big economic winner and also boosted the returns of both the S&P 500 index **SPX**, +0.14% and Dow Jones Industrial Average **DJIA**, -0.00%.

To put this crucial moment in Robert Frost-like terms, policymakers are being presented with two economic roads that are diverging, and the one chosen will make all the difference concerning our future levels of prosperity and economic well-being. Time is of the essence.

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