

# Is the US economy on the Japanese road?

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There is growing concern in leading financial circles and sections of the financial media that whether or not the current downturn in the US economy leads to a recession—defined as two consecutive quarters of negative growth—there is something more to the present situation than the “normal” workings of the business cycle.

The prevailing opinion, at this stage, appears to be that while the US economy may experience a downturn, and even quite a sharp one, it will soon resume an upward path.

This view was summed up in comments last Monday by New York Federal Reserve President William McDonough who said the US would begin an upturn by the second quarter and that by the second half of the year growth would be “quite strong.”

McDonough was echoing the views of the Federal Reserve Board which last month promised a “rapid and forceful response” to the economy’s decline as it cut interest rates by a further 0.5 percent in an effort to bolster the stock market and prevent a collapse in consumer confidence.

But while official opinion at the Federal Reserve is that the recession, if it does take place, will be “V-shaped”, others are not so sure.

The Levy Institute’s Forecasting Center warns that the consequences of what it calls the “underestimated recession”—a product of long-developing imbalances between the size of the economy and the magnitude of its debt and fixed assets—will be “long and severe.”

According to the Center, the present situation has a “particularly threatening feature: the pathologically inflated corporate equity market,” which means that the economy’s vulnerability to a stock market decline is “unequaled in US history.” “Overall,” it concludes, “the present situation involves the most formidable financial dangers since the 1930s.”

Other observers are concerned that even if the present downturn is quickly followed by a resumption of growth, this will only mean that none of the long-term structural imbalances of the US economy have been overcome, setting the scene for even bigger problems in the future.

This appears to be the prevailing view across the Atlantic. In an editorial published on February 2, entitled “Fed to the rescue—for now”, the London-based *Financial Times* noted that the two interest rate cuts of 0.5 percent each in January had restored confidence in financial markets reflecting a “consensus that the Fed can and will solve the current difficulties.” However, the editorial continued this “happy outcome misses a crucial point.”

“Such a scenario would not be the ‘soft landing’ the US needs. It would be no landing at all. As the latest research from Goldman

Sachs highlights, ‘the private sector financial deficit [the excess of private expenditure, corporate and personal, over income] in this forecast would remain at about 6 percent of GDP over the next two years. Furthermore, the current account deficit would remain at close to 4.5 percent of GDP.’ The dangers of a subsequent sustained period of low or negative economic growth would remain.”

The editorial concluded by noting that the confidence in the equity markets was based on two premises. “First that economic policy can sort out the current economic difficulties. That may be true. Second, that once the US economy recovers, it can continue growing indefinitely, as it has in the past decade. That is not true. Short-term success in averting a recession is most likely to be achieved at the expense of long-term imbalances that cannot be sustained.”

A similar view was expressed in an editorial published on February 1 in *The Economist* magazine commenting on the interest rate cuts.

“The only way that rate cuts might work swiftly,” it noted, “is by encouraging a rebound in share prices. Since the beginning of January the Nasdaq has gained around 20 percent, and the widest stock market index 8 percent. Continued rises could help to restore household wealth and help confidence. But there’s the rub. Suppose the Fed does succeed in buoying share prices and consumer spending, and thereby steers around the recession—with the economy growing by around 2 percent this year, rising to 3 percent next year. That perfect ‘soft landing’ would do little to reduce America’s various economic and financial imbalances. The debts of households and firms would remain alarmingly high. Share prices would remain overvalued: yes, they are still overvalued, despite last year’s decline. And the current account deficit would continue to loom large.

“One day these imbalances will have to be addressed. If the Fed succeeds in preventing a recession today and economic confidence bounces back, that day will not merely have been postponed. In such circumstances the imbalances are likely to keep growing. In due course, that would put the economy at risk of an even harder landing than it is now.”

The chief problem confronting US financial authorities and policymakers is that the so-called “imbalances” in the economy—the growth of private debt and the balance of payments deficit—were not simply the “bad” side of economic growth, particularly over the past five years, but were essential to it.

There is no question that the application of new technologies, which increased the productivity of labour, played a key role in raising the US growth rate from around 2.5 percent per annum to 4

percent and above from 1995 onwards. But that was not all there was to it. If improved technology, so to speak, increased the capacity of the economic engine, then increased spending, financed by a rise of indebtedness, both personal and corporate, was the fuel which powered it.

However, the hi-tech driven boom has now run into one of the central contradictions of the capitalist economy—the fact that investment is not undertaken because it increases productivity and output per se, but insofar as it results in increased profits.

Increased productivity brought forward greater investment so long as there was an expectation of rising profits, resulting from lower costs, increased sales, inflated asset prices or a combination of all three. But the very expansion of productive capacity has now led to a situation where the high profit expectations of the past cannot be realised. Indeed, as a consequence of the increased productivity induced by past investments, every industry in the US is increasingly confronted with the problem of overcapacity, resulting in increased competition and falling profit expectations.

### **The “Japanese road”**

This situation has now raised fears that instead of enjoying a so-called “soft landing”, the US economy may well be on the “Japanese road”—a period of overcapacity and stagnation, combined with falling asset values, like that which has characterised the Japanese economy since the collapse of the stock market and real estate bubble of a decade ago.

In a speech late last month, former US Treasury Secretary Lawrence Summers pointed out that the present economic situation was different from previous post-war cycles. Previously, he said, increased demand led to rising inflation, which forced the Federal Reserve to lift interest rates and induce a recession. But the expansion of the past five years has been much more like pre-war cycles or that of Japan in the late 1980s in which the expansion of credit has played the key role. According to Summers, the absence of inflation allowed the expansionary phase to continue for much longer than otherwise would have been the case, but at the cost of a greater accumulation of debt.

Of course, the major problem in such situations is that when the downturn comes, the assets financed by the increased debt undergo a rapid deflation, leading to severe losses, cuts in investment, falling demand, and a further reduction in asset values—in short, the replacement of the virtuous circle, which operated in the period of expansion, with an increasingly vicious one.

In an editorial comment published on January 27, *The Economist* noted that while there were considerable differences, “there are enough eerie similarities between America today and Japan in 1989-90 to be worrying. The biggest is excessive debt. Too much debt was always at the heart of Japan's weakness. So it is alarming that America's boom has been fuelled by massive borrowing by companies and households.”

Japan, it pointed out, was not unique and “America is but one more example of an age-old phenomenon in which rapid increases in asset prices encourage a credit binge and overinvestment that proved unsustainable once asset prices fell.”

Stephen Roach, the chief economist at the investment firm Morgan Stanley Dean Witter, is another commentator to draw parallels between the US and Japan. In an article published in the

*Financial Times* on January 31, he noted that: “While the US economy stands little chance of succumbing to the Japanese disease, it could well fall victim to a strain of its own.”

According to Roach, given the “excesses” of debt financing, “The obvious and important question is this: what happens to this vast reservoir of debt when the excesses of its collateral—the installed IT [information technology] base in the real economy—start to get eliminated?”

If the fall in the stock market led to a drop in consumer confidence and a swing back in the personal savings rate from its current level of minus 0.8 percent towards its long-term average of 8.5 percent before the boom which began in late 1994, “consumer demand could be sharply depressed for years to come.”

“None of this was ever in the script of America's New Economy,” he wrote. “Nor was Japan, widely proclaimed as the new global powerhouse in the late 1980s, ever supposed to disappear into economic oblivion. Yet history is littered with the carcasses of new eras. As the first recession of the information age begins to unfold, the lessons of Japan should not be taken lightly.”

Roach did not advance any reasons as to why this experience was ignored. But they are not hard to find.

The collapse of the Japanese financial bubble at the beginning of the 1990s was lost in the wave of “free market” triumphalism which greeted the breakdown of the Stalinist regimes in the Soviet Union and Eastern Europe.

Then came the “new economy” boom which began in the mid-1990s. Insofar as the continuing Japanese stagnation was examined, it was in order to emphasise the supposed superiority of the “US model.”

But in the light of the severe crisis now gripping the US economy—whether or not this brings outright recession in the immediate period—there are now the beginnings of a recognition that what took place in Japan may well have been a particular expression of an essentially global process.



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