Fiscal lessons from Japan's recession

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In 1997, Japan raised VAT and lowered its government spending, sparking another recession. Is there a lesson for Spain in Japan's economic history? Japan provides salient lessons for what governments can do, and what they should not do, to spark economic recovery.

Spain's current recession bears more than a few similarities to the recession in Japan in the 1990s, though there are significant differences as well, notably in the timing of a plunge in real-estate prices and loan growth.

So what lessons can Spain take away from Japan's experiences? Can Japan provide any guidance for what the Spanish government can do to stimulate economic growth?

In "Spain, Japan and the Dangers of Early Fiscal Tightening," professors R. Anton Braun and Javier Díaz-Giménez examine the similarities and differences in Spain and Japan's recessions. They propose a model to assess the effectiveness of Japan's fiscal policy and recommend an economic strategy for Spain.

The recession in Spain, following more than a decade of strong growth, is tied, in part, to the subprime crisis in the United States and encompasses falling equity prices, declining real growth, rising unemployment, decreasing land prices and a rise in nonperforming loans. At this point, it is unclear whether the recession will be long-term, and it is vital that the Spanish government takes no missteps in spurring economic recovery. To formulate a strategy, Spain can look to Japan for guidance.

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Troubling differences

Japan's current recession is not the first time the country has suffered a reversal of economic fortune; its financial bubble burst in the 1980s. What is interesting is that the Japanese economy soared in the 1980s, only to collapse in 1997, leading to a long recession. It is this former sequence of events from which Spain may draw valuable lessons.

There are many factors that make up the current recessions in Spain and Japan, some of which the countries have in common. For example, both countries have experienced declining stock prices, falling real-estate prices, deflation, lower real economic activity (GDP) and a decline in manufacturing.

The countries differ in other areas: Spain has seen more disruption to its labor market; Japan has seen sharper declines in exports and imports; Japan's bank lending is falling more rapidly than Spain's; the countries have vastly different short-term interest rates; and Japan has much more government debt than Spain.

Perhaps the most troubling difference between the two countries, write the authors, is that Spain's "real-estate prices had been rising rapidly for over eight years prior to the financial meltdown and much of this growth was financed by rapid increases in domestic bank lending," affecting both borrower and bank lending behavior.

Steps that led to 1997 recession

There are some interesting similarities between Spain's current recession and Japan's recession in the 1990s as well, providing an opportunity "to see what lessons we can learn from the aftermath of Japan's previous financial bubble that can be used to guide current policy in Spain."

Once again, both countries have in common economic triggers including stock markets, real estate, consumer price inflation, bank lending, monetary policy and fiscal policy. They differ when it comes to GDP, manufacturing, labor markets, international trade and bad loans.

When Japan's economic bubble burst in the 1980s, Japan did not immediately enter a recession; indeed, real growth and unemployment were stable for several years.

However, in 1993, unemployment began rising, and GDP growth slowed. Japan's authorities reduced the call rate, increased fiscal expenditures and employed tax cuts to spur recovery.

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By 1996, the economy was strengthening, and so, in 1997, Japan took new steps to reduce its deficit: it removed the income tax reduction, increased the consumption tax and increased out-of-pocket medical expenses.

The result? A major recession, the most serious since World War II. It seems Japan reversed its fiscal course too soon.

Raise VAT, reduce spending: Wise move?

In 2007, Japan raised VAT and lowered its government spending, sparking another recession. Spain, too, plans to increase VAT in 2010 and is considering reducing its own government spending. Is there a lesson for Spain in Japan's economic history? If so, how can this lesson be quantified and defined?

A New Keynesian model provides a method for assessing Japan's economic past and extrapolating lessons for Spain's current fiscal direction. By evaluating a representative household, a representative final good producer, a continuum of intermediate good producing monopolists, a government and a central bank, a sound fiscal policy can be determined.

The model provides a few important insights about Japan's fiscal tightening in 1997: that "the share of government purchases in output fell between 1996 and 1997 by 3 percent"; that VAT grew by 2 percent; and that Japan's fiscal policies took place "against a background of inflation rates of about zero."

To test the wisdom of fiscal tightening, the model can accommodate a variety of counterfactual exercises to assess the tightening's quantitative role.

The result? It may be surmised that "the depth of the 1997 recession could have been significantly attenuated if fiscal policy had not been reversed so quickly."

Spain would do well to take this to heart, and refrain from tightening its own fiscal policy too hastily, say the authors.

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