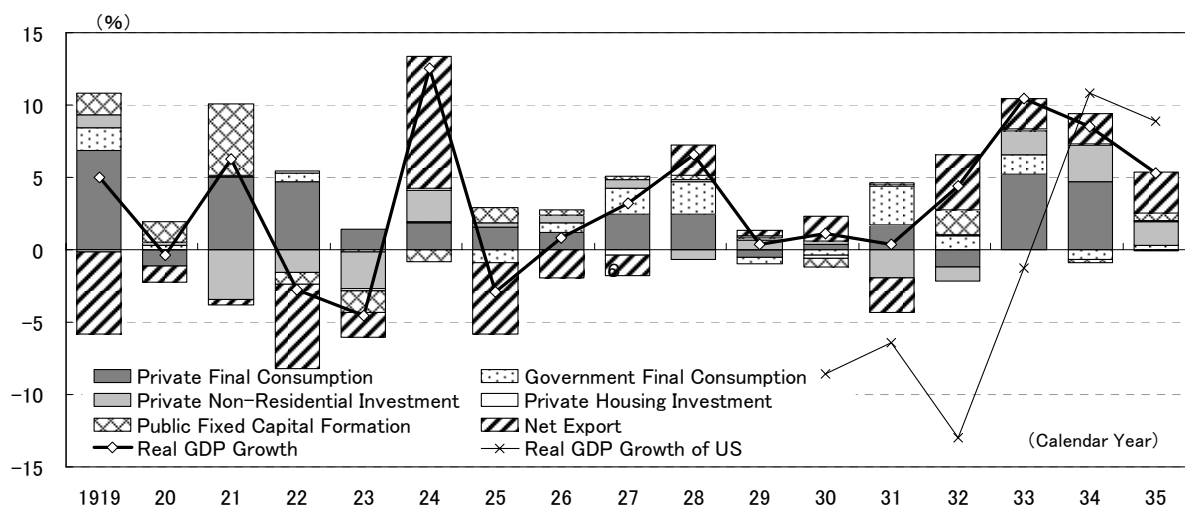


Showa Depression: a Prescription for “Once in a Century Crisis”

Yuji Kuronuma

- Deep FY2008-2009 recession recalls 1920's and 1930's
- Similarities include stubborn deflation, synchronized global slump, and strong yen
- Options include massive fiscal spending, increased government bond buying by BoJ

Figure 1. Real GDP Growth Rate of Japanese Economy in 1919–1935



Note: Real GDP and the components of expenditure side are 1934–1936 prices based on the source listed below, same as real values in Figure 2-7 unless otherwise noted. The components are represented by contribution rates.

Source: Kazushi Ohkawa, Miyohei Shinohara and Mataji Umemura, eds. *Long-term Economic Statistics*; U.S. Department of Commerce.

It's being called the biggest slump and the worst contraction since the war. Across the board, official Japanese economic indicators released over the past few months have been the worst since the World War II. Politicians and Business managers agree it's a “once in a century crisis”. All this leads to the question of how things actually were before the war or “a century ago” (Figure 1). Although few Japanese economic indicator data series traces

back before the war based on consistent criteria, I've assembled data from a number of sources, including the several volumes of the prewar data collection *Long-Term Economic Statistics* as well as the Bank of Japan's publication *Hundred-Year Statistics of the Japanese Economy* with the aim of linking the prewar and modern data to find what a comparison might reveal.

In our economic forecast released February 17, we projected that the real GDP growth rate for fiscal year 2009 (April 2009 - March 2010) would fall to -3.7% versus the year before. This figure does indeed represent the largest contraction in the postwar period. In the prewar period, however, real GDP growth reached even worse levels between 1920 and 1930 (Figure 2). The extraordinary demand associated with the First World War gradually vanished, after which Japan was struck by the Great Kanto Earthquake. The rate of real economic growth was -2.7% in 1922, -4.6% in 1923 and -2.9% in 1925 as Japan experienced a deep recession in a short period of time. The real economic growth rate stayed just 1.1% in 1930 and 0.4% in 1931, when the global depression following Black Thursday (October 24, 1929) on Wall Street reached Japan. But with the severe deflation caused partly by the lifting of the gold embargo, Japan's GDP growth rate plummeted to -9.7% in 1930 and -9.5% in 1931 on a nominal basis (Figure 2).

During the Great Depression, governments around the world failed to take measures to rescue damaged financial institutions or to encourage demand, instead turning impulsively to protectionism. In contrast, government and central banks are now attempting to work out countermeasures against the crisis. However if this is indeed a once in a century crisis, surely it is time to consider measures similar to those of then Minister of Finance Korekiyo Takahashi, whose fiscal policies are credited with ending the Showa Depression. These measures included such extraordinary tools as a massive fiscal stimulus measures, greatly increased Japanese government bond issuance and underwriting of that bond by the BoJ.

Business firms succumb to persistent deflation

Deflation persisted in the 1920's (Figure 3), with business firms suffering declining revenues and bearing increasingly heavy debt burdens in real terms. In some industries, they formed cartels in a bid to maintain prices, but these failed for lack of cohesion. A succession of bankruptcies and buyouts continued, with the number of machine tool makers, for example, plummeting from over a hundred in 1920 to just over ten in 1929^[1].

Amid such severe business conditions, companies tended to remain cautious regarding fixed investment even though production output might rise somewhat (Figure 4). With the population expanding at a pace of 1.5% per year on average, personal consumption in the 1920's was firm, but fixed investment remained quiescent (Figure 1). The decline of prices on Wall Street, which marked the start of the Great Depression, began in October of 1929, just as Japan was groping through the maze of its own growth slump.

The present crisis resembles the Showa Depression in three ways. First, the trend over the past ten years has been deflationary on the whole. Second, a synchronized global recession has emerged that was sparked in the United States. Third, the yen appreciates on international currency markets. The resurgent yen occurred owing to Japan's return to the gold standard in January of 1930 under the policies of then Minister of Finance Junnosuke Inoue. The Japanese currency appreciated about 7% against the dollar's average value for the year 1930. The majority of industrialized nations returned to the gold standard by the middle of the twenties, and although

supporters of the gold standard were predominant in the business world as well, the timing was bad. Owing to the depression, demand in the United States and other major importers of Japanese goods declined, while the strong yen undermined the price competitiveness of Japanese products. As a result, exports mainly of fabrics and other goods plummeted (Figure 5). Today, Japanese companies find themselves in a similar position.

Japan's real economic growth just managed to stay positive over the two years of the Showa Depression, but in fact the real growth rate was pushed up as the GDP deflator fell in tandem with rapidly declining prices. Another factor was the extraordinary demand associated with the rapid increase in government expenditures following the Manchurian Incident in 1931.

Fiscal stimuli and inflation expectations turn tide

After taking the helm as Minister of Finance, Takahashi quickly worked out a number of measures, removing Japan from the gold standard and announcing that the BoJ would underwrite government bond (Table 1). He abandoned the Inoue's golden rule of fiscal austerity, and in fiscal 1932 boosted combined fiscal spending from the general and special accounts by 34% over the year before (Figure 6). The government financed the spending by doubling issuance of government bond (Figure 7). In order to provide relief for farmers who were suffering from eroding prices on agricultural goods and declining fabric exports, the government boosted subsidies, which in effect amounted to public works spending, for the agriculture and construction industries (Figure 6). The total increase in fiscal

expenditures for fiscal 1932 amounted to over 10% of GDP, and the total value of government bond issuance rose to over 8% of GDP.

The defining feature of Takahashi's fiscal policies was not just massive fiscal stimuli. They clearly provided for monetary easing premised on the underwriting of government debt by the Bank of Japan and thus encouraged inflation expectations. These expectations were not the consequence of tight supply and demand conditions in goods and services markets^[2]. In fact, prices first turned up again in 1932 (Figure 3), and as a consequence, the debt burden was lightened in real terms. Production and investment then began to recover the following year (Figure 4).

Table 1. Takahashi's Footprint

Dec. 1931	Takahashi assumed Minister of Finance, re-prohibited gold exports
Jan. 1932	Left the Gold Standard formally
Mar.	Announced the plan to underwrite government bond by the Bank of Japan Cut the discount rate of commercial bills from 6.57% to 5.84% per annum "Law of government securities issuance to finance Manchurian Incident" came into force
May.	5.15 Incident
June.	Cut the discount rate to 5.11%
July.	"Law preventing capital flight" came into force
Aug.	Cut the discount rate to 4.38%
Nov.	Started to issue long-term government bonds underwritten by the BoJ
May. 1933	"Foreign exchange control law" came into force
July.	Cut the discount rate to 3.65%
July. 1934	Announced plans of restoring budgetary balance, reducing government bond issuance, etc.
June. 1935	Announced the plan to reduce government bond issuance on budget project of fiscal year 1936
Feb. 1936	2.26 Incident, Takahashi was killed
Mar.	Hirota Cabinet started and reversed the existing plans to reduce government bond issuance, etc.
July. 1937	The Marco Polo Bridge Incident erupted and plunged into the China-Japanese War

Source: Kikuo Iwata, ed., *Studies on the Showa Depression*, Bank of Japan, *Hundred-Year Statistics of the Japanese Economy*

A role for Takahashi's fiscal policies now

At a press conference held in November of 2008, BoJ Governor Masaaki Shirakawa pointed out that the manner in which nations around the world are responding now differs

from how they responded then in several ways. First, governments took no effective measures to cope with the failure of financial institutions in the 1930's. Now, governments, central banks and financial institutions around the world are taking action to do so. Second, the policies of the 1930's focused on monetary and fiscal belt-tightening, whereas now they are accommodative. Third, the thirties saw the rise of protectionism, but now free trade is being upheld.

To be sure, monetary and fiscal policies around the world are accommodative. The question, however, is whether such policies are accommodative enough to cope with the present crisis. That question will be determined by whether or not such measures are sufficient to stimulate consumption by households and production and fixed investment by business firms.

Japanese households are currently cutting back on expenditures to guard their livelihood, and business firms are holding the line on investment and labor costs in a bid to survive. The financial positions of financial institutions have gradually worsened owing to the decline in stock prices and other factors. The government is burdened with a fiscal deficit, and its economic measures have been piecemeal. The BoJ has already lowered rates nearly to zero, and although it has resorted to nontraditional monetary policies such as buying commercial paper and corporate debt, it is still groping. If deflation becomes serious, households and business firms would be in great danger from heavier debt burdens in real terms.

The current situation resembles that prevailing at the time of the Showa Depression under

deflation. The Takahashi fiscal policies not only created demand through expanded fiscal expenditures but included reflationary measures aimed at restoring gradually rising prices, thereby turning the tide of deflation. In 1933 and 1934, personal spending and business fixed investment once again fuelled a growing economy.

If we look to Takahashi's policies for a prescription to the present "once in a century crisis," a package of measures along the following lines might be suggested. With a massive issuance of government bond equivalent to 8% of GDP, the government could finance a double-digit year-on-year increase in spending for fiscal 2009, including the supplementary budget. The BoJ for its part would also step up outright buying of government bond and adopt a policy of inflation targeting. Of course, the Japanese military government from 1936 came to regard government bond issuance as a magic lamp (Figure 7), but if the lessons of that mistake are learned, such issuance should be limited strictly to achieving an economic recovery.

When the times change, so do policy tools. But the fact remains that restoring the confidence of business and households will be critical in pulling our economy out of such a deep recession. The Takahashi policies provide one example of how to accomplish that.

(Researcher from the Nihon Keizai Shimbun, NIKKEI. Short-Term Economic Forecast Team in 2007-08)

(The original Japanese article appeared in the March 10, 2009, as a report in a series of columns named "Keizai Hyakuyobako")

Notes:

- [1] Hiromi Arisawa, ed., Nihon Sangyo Hyakunenshi (One Hundred Years of Japanese Industrial History). [2] Kikuo Iwata, ed., Showa Kyoko no Kenkyu (Studies on the Showa Depression).

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Figure 2. Growth Rate of Japanese Economy

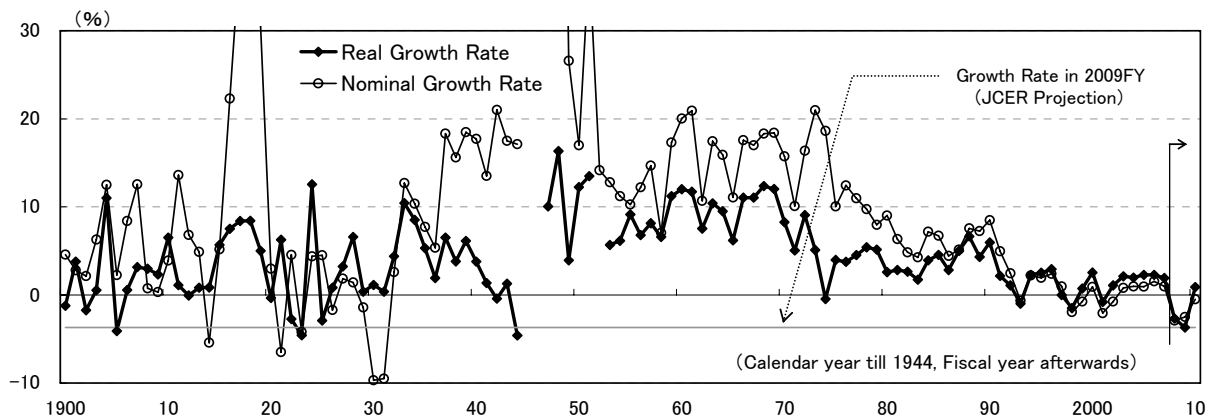


Figure 3. Indices of Consumer Price and Producer Price

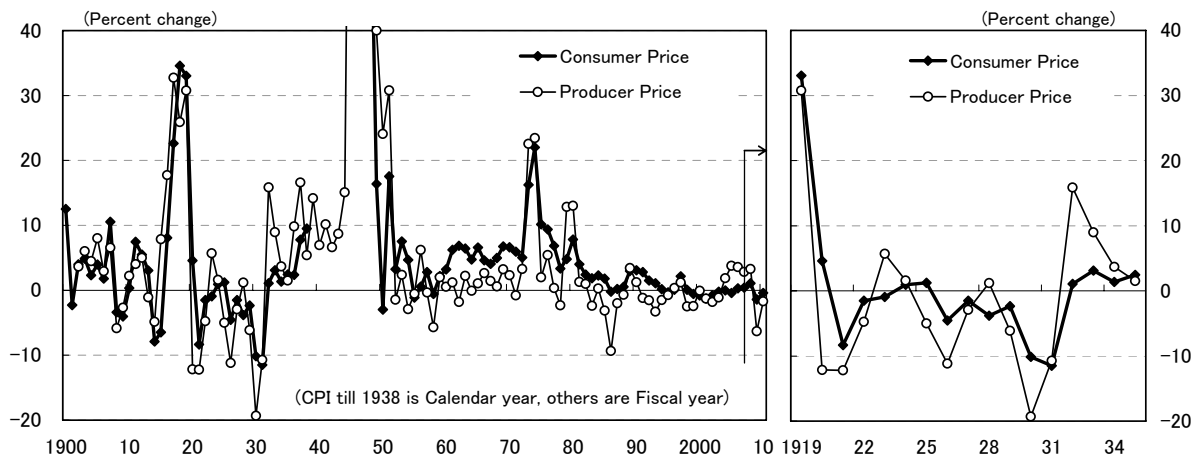
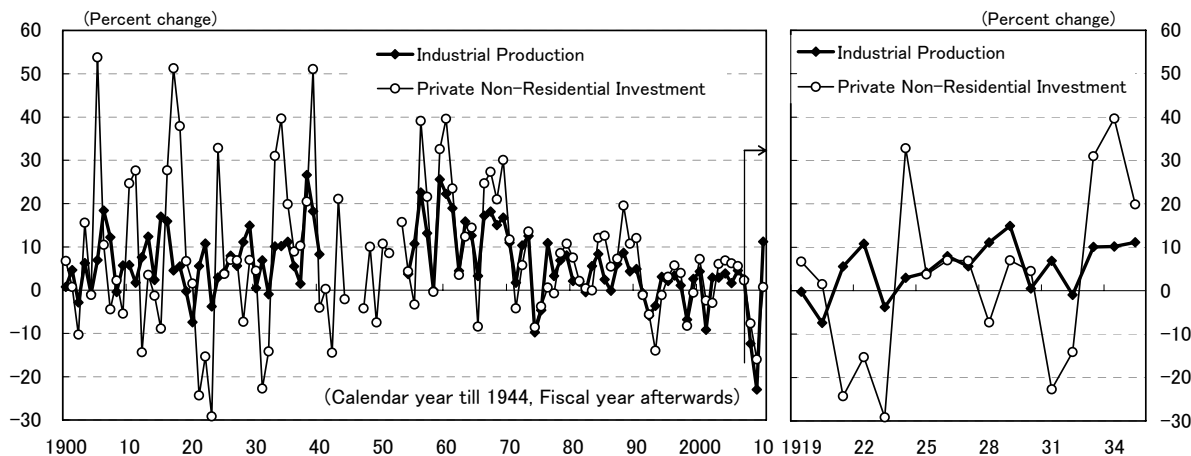


Figure 4. Production and Investment



Note: Real GDP in 1941-55 are Gross National Expenditure (1965 prices), and growth in the postwar period are simple connection of 1968 and 1993 SNA (Figure 2). CPI in the postwar period is general index excluding imputed rent, CPI in 2008-10 are JCER projections of general index. PPI up to 2007 are “Prewar Base Index” publicized by Bank of Japan, and PPI in 2008-10 are JCER projections of domestic corporate goods price index (Figure 3). Industrial productions till 1940 indicate net domestic product of manufacturing and mining, and private non-residential investments include housing only in 1941-51 and are 1965 price only in 1953-55 (Figure 4).

Source: Ohkawa etc. eds. *Long-term Economic Statistics*; Cabinet Office; Ministry of Internal Affairs and Communications; Bank of Japan; Ministry of Economy, Trade and Industry.

Figure 5. Nominal Export Growth Rate and Contribution by Destinations

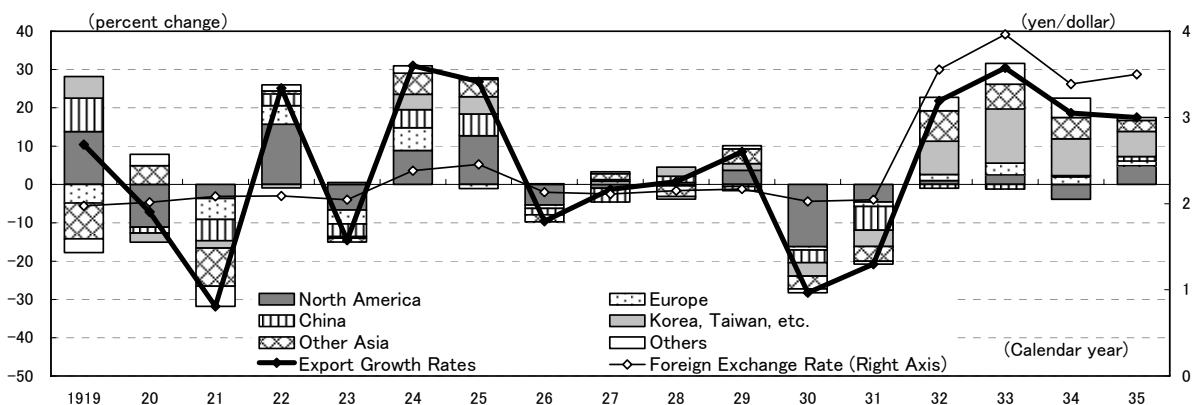


Figure 6. Fiscal Expenditure in 1919–1940

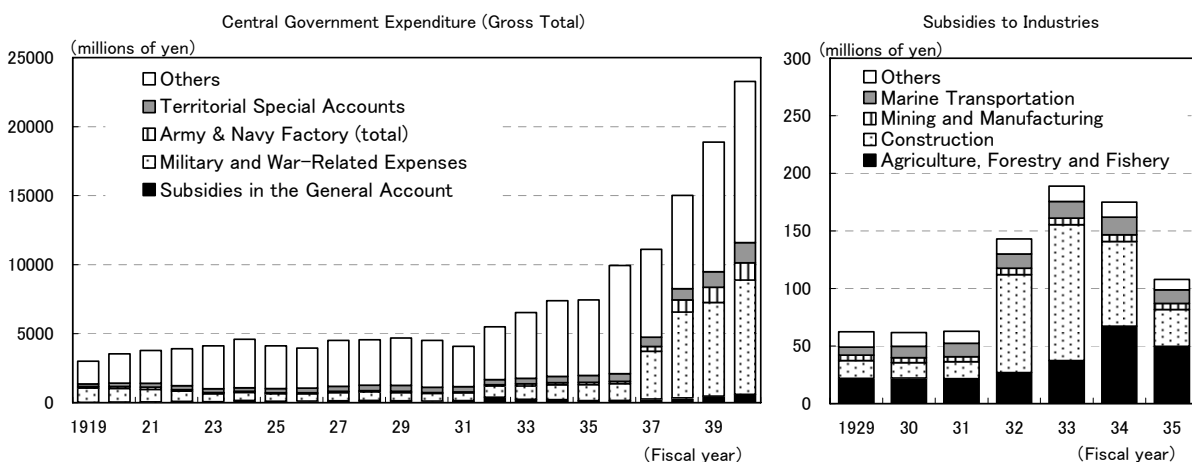
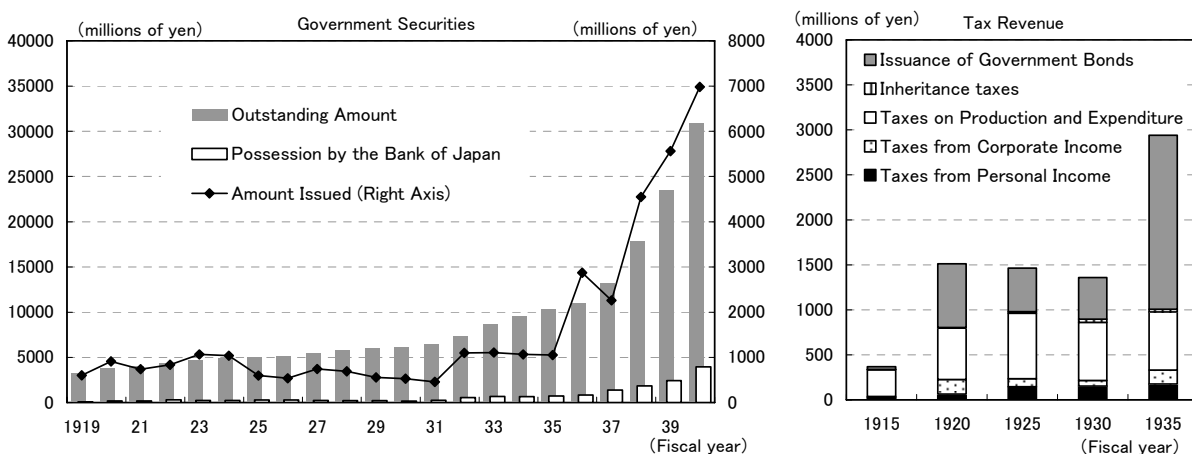


Figure 7. Issuance of Government Bonds



Note: Korea, Taiwan, etc. includes Kwangtung Province and Manchuria (Figure 5). Central Government Expenditure is sum of general and special account, only excluding special account of iron manufactory. Military and war-related expenses is mainly made up of Army and Navy expenses in general account. Army & Navy factory includes Navy arsenal fund (Figure 6). Short term Government Securities are included in the outstanding amount, but not in the amount issued. Taxes on production and expenditure are mainly made up of selective sales and property transfer taxes (Figure 7).

Source: Ohkawa etc. eds., *Long-term Economic Statistics*; Bank of Japan, *Hundred-Year Statistics of the Japanese Economy*.