THE WALL STREET JOURNAL.

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REVIEW & OUTLOOK

Japan's Keynesian Recession

The familiar advice to spend more and raise taxes fails again.

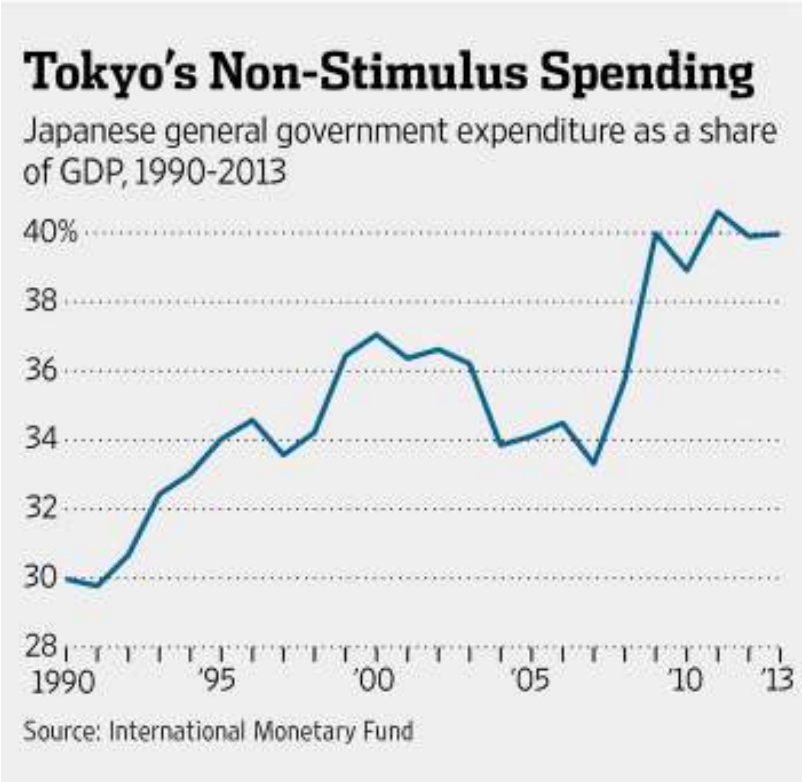
The skyline of Shinjuku in Tokyo. *AGENCE FRANCE-PRESSE/GETTY IMAGES*

Nov. 17, 2014 7:28 p.m. ET

Shinzo Abe has made little secret of his plans to postpone next year's consumption-tax increase and call a snap election. Monday's third-quarter GDP statistics show why the Japanese Prime Minister may be rediscovering his political backbone. Japan's economy contracted at a 1.6% annual rate, meaning the country is officially in recession.

The numbers surprised analysts, who had predicted a bounce after the April 1 consumption-tax increase tanked the economy in the second quarter. Instead consumption barely budged and is still down 4.7% since April. Companies chose to play it safe and drew down inventories rather than increase production. The real economy contracted more severely than the GDP numbers suggested, since a fall in imports inflated the trade surplus.

The third quarter continues a depressing pattern. This is Japan's fourth recession since 2008, and even when the economy is technically growing it remains on life support. Annual growth has averaged 0.85% since 1992.



This year's contraction is much worse than that of 1997, the last time Japan increased the consumption tax. That recession was dismissed by the Ministry of Finance mandarins as a fluke or the result of the Asian financial crisis. They were wrong.

Now they warn that if Mr. Abe postpones next year's planned consumption-tax increase to 10% from 8%, Japan's fiscal credibility will suffer and financial markets will punish the country. That is belied by the stock market's positive response this month to rumors that Mr. Abe is about to announce a delay.

The Prime Minister desperately needs to re-establish his economic-policy credentials as growth slumps and his popularity declines. Mr. Abe raised hopes in 2012 that he could reinvigorate Japan, and voters gave him a large majority in parliament. So far he has squandered that opportunity by setting the wrong priorities.

Mr. Abe overcame resistance within the Ministry of Finance and Bank of Japan to appoint BOJ Governor Haruhiko Kuroda, who has pursued aggressive monetary bond-buying. But inflation has barely budged and lending is flat; businesses complain that they've been hurt by the weakening yen. Mr. Kuroda doubled down on Oct. 31, but so far he has only delivered more proof that monetary policy alone can't sustain economic growth.

If there's a silver lining, it's that Mr. Abe challenged the Finance Ministry's power over elected politicians. If he cancels the consumption tax increase and wins an election as a result—more than 70% of the public opposes the increase—he will have sent a useful message.

Meanwhile, the Prime Minister is reported to have acquiesced to another classic Finance Ministry blunder, a supplementary budget of five trillion yen ($43 billion). Since Japan's bubble economy burst in 1990, Tokyo has tried to spend its way back to prosperity. Government expenditure has risen to about 40% of GDP from 30%, and national debt has swelled to 227% of GDP. (See the nearby chart.) The additional spending provides only a temporary growth blip, but debt rises and then taxes rise to finance it, harming growth and further increasing debt.

In the snap election, voters are likely to trim Mr. Abe's 61% majority in the lower house of the Diet. But he should get a second chance to turn an electoral mandate into national revitalization. To do so, he has to deliver on the most important part of his economic program, the stalled "third arrow" of reform to liberalize the domestic economy and cut tax rates.

More than Japan's future is at stake. Since 2008 the U.S. and most of Europe have copied Japan's strategy of government-driven growth, and the result has also been bigger governments with less growth. Having tried everything else, Mr. Abe will have to embrace supply-side reform if he wants to fulfill his growth promise.