Saving Japan

Forget inflation targeting. Tokyo instead needs to implement a one-two, monetary-fiscal punch.

BY RICHARD KATZ

Japan's deflation is back. And during the worst recession in Japan's post-war era, deflation is correspondingly almost twice as bad as during any previous decline. In fiscal 2009 (which ended on March 31), the deflator for the domestic components of GDP fell by 3 percent from a year ago.

Like his Liberal Democratic Party predecessors, Naoto Kan, the Democratic Party of Japan's Minister of Finance [now Prime Minister], has put the onus on the Bank of Japan to cure deflation. He talks as if deflation were the root cause of economic stagnation and as if the Bank of Japan had a magic wand (sometimes called "inflation targeting"). Kan and the Ministry of Finance are reluctant to use fiscal stimulus. On the contrary, Kan is talking about raising the consumption tax as soon as possible in the next few years, thereby risking a repeat of the recession-triggering tax hike of 1997. It's easier to justify this stance by claiming that monetary ease alone, not a fiscal-monetary combination, is the pivot for recovery.

NO DEFLATIONARY SPIRAL

The good news is that there is no "deflationary spiral" like the United States suffered in the 1930s. In such a spiral, a collapse of jobs and demand sends prices plunging. That, in turn, makes people and companies postpone major purchases (just like fewer Americans bought homes during the recent crash). That leads to even more drops in demand.

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The United States Is Not Japan

During the dot.com bust and again today, alarmists claim that the United States could end up reprising Japan's "lost decade." It's not true. The situations are very different.

Japan's primary problem was pervasive dysfunction in the economy, which was reflected in, among other things, a banking crisis. In the United States, by contrast, the primary problem was pervasive dysfunction in the financial system, which caused a deep recession in the real economy. In Japan, the dysfunction stemmed from deep-seated structural flaws requiring institutional reform. In the United States, the dysfunction was the result of grave—but correctable—policy mistakes, from allowing "liar loans" in housing to refusal to regulate derivatives. Congress is enacting the needed reform bill as we go to press; whether this proves sufficient remains to be seen.

In Japan, the bad debts added up to 20 percent of GDP. In the United States, the International Monetary Fund estimates, banks' write-downs of loans and securities will amount to about 6 percent of GDP. In Japan's crash, land prices fell 90 percent and are still near the bottom. U.S. housing prices fell about 30 percent to 2003 levels and appear to have stabilized.

It took the Bank of Japan nearly nine years to bring the overnight interest rate down to zero. The U.S. Federal Reserve did it in sixteen months, and it successfully applied unconventional measures to fight the credit panic. It took Tokyo eight years to recapitalize the banks; Washington began to do so in less than a year. For a few years, Tokyo used government money to help the banks keep lending to insolvent borrowers; U.S. banks have been rapidly writing off their bad debt. Tokyo's fiscal stimulus was too little, too late and too stop-go. America's massive fiscal stimulus helped prevent disaster from turning into cataclysm.

As for deflation, both the U.S. Federal Reserve and the Obama Administration have learned from Japan that an ounce of fiscal-monetary prevention is worth tons of attempted cures.

—R. Katz

Fortunately, Japan's mild deflation merely reflects the long stagnation, but has not made it worse. The best way to see this is to compare the course of deflation to the "output gap." That is the gap between actual GDP and what GDP would be at full employment and full use of factories, office buildings, and so on. Today, the gap is about 7 percent of GDP. When demand weakens, prices turn soft. So, the past twenty-five years have seen a very high 86 percent correlation between the ups and downs of the output gap and those of inflation/deflation two quarters later (see Figure 1). While a worsening output gap has worsened deflation, the reverse is not true.

The major problem is that deflation prevents the Bank of Japan from using negative real interest rates (that is, interest rates below the rate of inflation) to stimulate demand. Since 1995, the Bank of Japan has pushed overnight interest rates down to near-zero and then zero. But nominal rates cannot go below zero. Deflation renders conventional monetary policy impotent.

To get around this "zero bound" problem, some monetary economists claimed that "quantitative easing"—printing tons of money—would be the magic bullet. The Bank of Japan tried this and it failed. The proposal was based on the fact that, prior to 1995, nominal GDP grew in tandem with the money supply in textbook fashion. But deflation has broken that normal linkage. Since 1995, the Bank of Japan hiked the money base 115 percent, but nominal GDP has fallen 8 percent.

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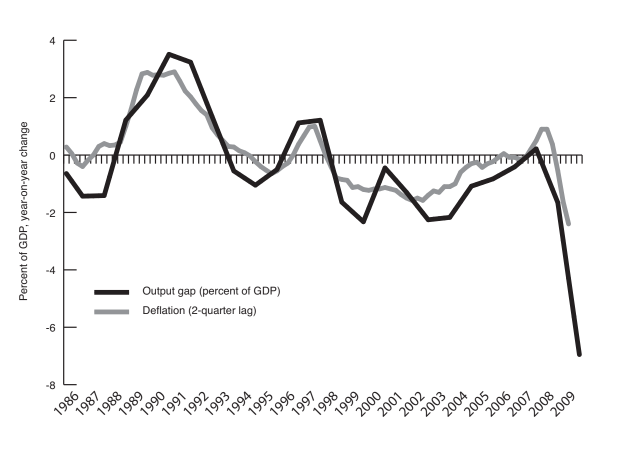
THE SIREN SONG OF INFLATION TARGETING

When quantitative easing failed, the call went out to combine quantitative easing with "inflation targeting." If only the Bank of Japan would set, say, a 2 percent target for inflation and promise to create enough money until the target was reached, then surely inflation would return—or so it was claimed. Bank of Japan Governor Masaaki Shirakawa has rejected such calls, as did his predecessors.

In countries with inflation, central banks have the tools to reach their target. If inflation is too high, they can raise interest rates and lower demand; if it is too low, they can lower rates and boost demand. However, because of the "zero bound" problem, there is no precedent for inflation targeting curing deflation (and no modern case except Japan of a rich country suffering prolonged deflation.) As Alan Blinder, former Vice Chairman of the U.S. Federal Reserve, replied to us in 2003, "I have not been an advocate of inflation targeting in Japan. If the Bank of Japan said it had a 3 percent inflation target, market participants would ask: 'Tell me how we're going to get to 3 percent inflation?' It would be very hard for the Bank of Japan to give a credible answer."

Based on "rational expectations" theories, proponents of inflation targeting argue as follows: Because people expect prices to fall, they postpone purchases. If they expected prices to rise, they would rush to buy now. Those purchases would, in turn, put upward pressure on prices. So, expectations of inflation are self-fulfilling. Inflation targeting works because the Bank of Japan promise will change expectations. This theory rests on several presumptions about behavior, all of which are completely contradicted by the data for Japan.

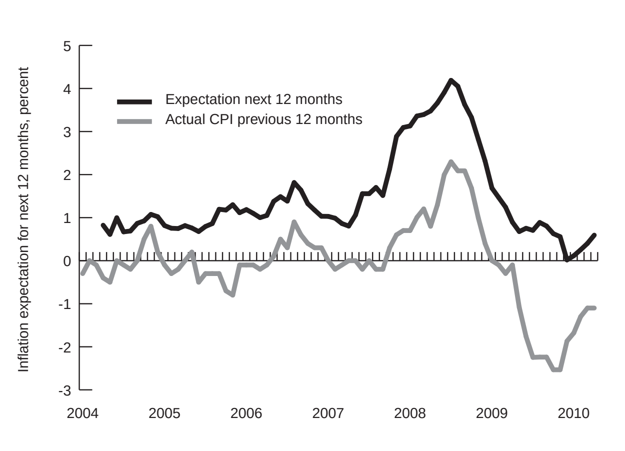
Figure 1: Weak demand produces deflation, not vice versa



Source: International Monetary Fund, Cabinet Office

Note: For definition of output gap, see text; deflation equals the domestic demand deflator in the GDP tables.

Figure 2: People keep expecting early return of inflation



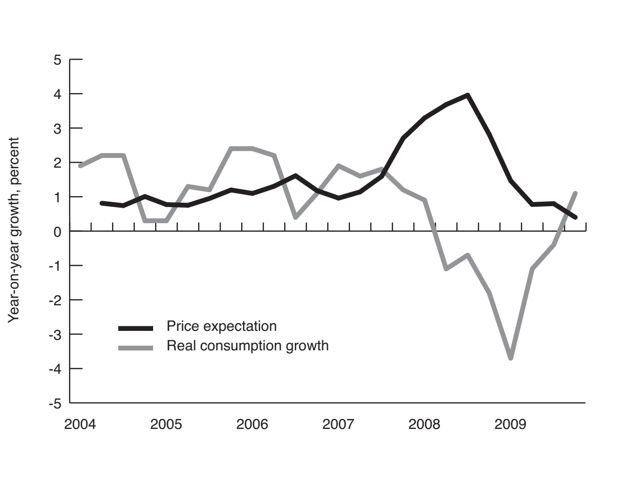
Source: Cabinet Office, Ministry of Internal Affairs and Communications.

Assertion 1: People in Japan expect intractable deflation. On the contrary, a survey begun by the Cabinet Office in 2004 shows that the Japanese people have consistently and wrongly expected inflation to return in the twelve months following every survey (see top black line in Figure 2). If the main problem were really self-fulfilling expectations, then why does deflation persist even though people expect inflation? This alone renders the entire inflation targeting argument invalid.

Assertion 2: People buy less due to deflation. If that were true, then the household savings rate would have risen. In reality, since 1995 when deflation took hold, the household savings rate has steadily decreased from 13 percent to 2 percent.

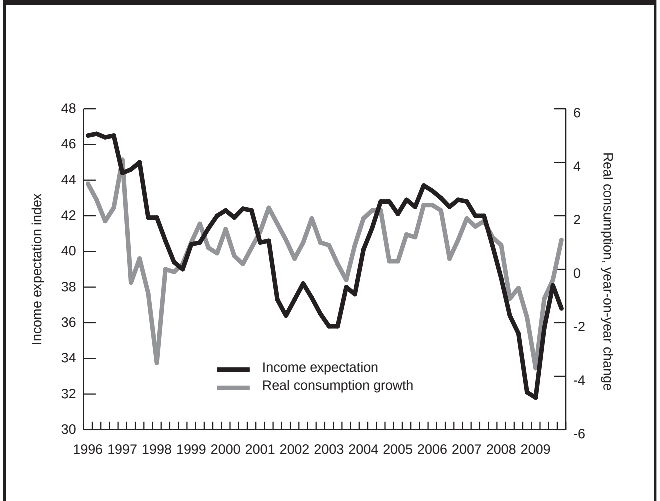
Assertion 3: The central bank can get people to expect inflation. The rational expectations theory requires ordinary people to know about, understand, and care about Bank of Japan policy. But another theory of behavior, called "adaptive expectations," says that most expectations for the near future are simple extrapolations from

Figure 3: Rising inflation expectations hurt consumer spending



Source: Cabinet Office, Ministry of Internal Affairs and Communications

Figure 4: Expectations about income drive spending



Source: Cabinet Office, Ministry of Internal Affairs and Communications

the recent past (think of momentum investors). Japanese behavior conforms to the second theory. A 2005 study showed that only half the people were even aware of major Bank of Japan actions such as zero overnight interest rates and quantitative easing. Even when they knew, only 10 percent said it affected their inflation expectations. Japanese consumers are terrible forecasters of the future; they are better at predicting the past. Expectations for the following twelve months show a very high 77 percent correlation with the Consumer Price Index for the preceding twelve months but with an inflationary bias (see how expectations and lagged CPI parallel each other in Figure 2).

Assertion 4: People will buy more if they expect prices to go up. Wrong again. When people expected more inflation, they bought less. During 2004–09, there was an 84 percent *negative* correlation between inflation expectations in one quarter and real consumption growth two quarters later (see Figure 3). The reason is simple. If people expect prices to go up, but they don't expect their income to rise as much, that means a cut in their real (price-adjusted) income. People expecting cuts in real income buy less. Income expectations, not price expectations, are the best predictor of consumer behavior (see Figure 4).

There is no precedent for inflation targeting curing deflation.

Japan's consumer spending has been so anemic over the past decade not because of deflation, but because of stagnant income. Real wages per worker have fallen every year but one in the past decade. Total real income from private-sector sources in 2008 (latest available)—that is, wages, income of self-employed, rent, interest, dividends, and so on—was only 3 percent higher than in 1997. It was only due to tax cuts and increased transfer payments that real disposable income was 11 percent higher.

Policymakers need to act in accordance with how people actually behave, rather than insist that people change their behavior to accord with abstract theories.

A FISCAL-MONETARY ONE-TWO PUNCH

What Japan needs to do is to narrow the output gap by injecting some real purchasing power into the economy. Neither monetary nor fiscal stimulus is sufficient by itself; a combination is necessary (but only as a first step in a longer-term solution).

From peak to trough, Japan's GDP fell a stunning 8.4 percent—plunges usually seen only in emerging countries. That's more than twice as bad as the 1997–98 recession or the recent U.S. recession. This downturn wiped out a stunning 70 percent of the entire recovery seen from late 2001 to early 2008. The consensus forecast is that it will take until 2012 or 2013 for Japan to recover the level of GDP first reached in 2008.

Prime Minister Naoto Kan should agree to the right kind of fiscal stimulus—consumption-enhancing tax cuts, income transfers, subsidies and public works for suburban infrastructure. In return, the Bank of Japan should announce that it is able and willing to keep long-term interest rates down—by buying government bonds if necessary. Fiscal stimulus would help narrow the negative output gap, which would ease deflation. That, in turn, would lower real interest rates and give monetary ease more punch.

Real wages per worker have fallen every year but one in the past decade.

Skeptics say that Japan tried fiscal stimulus in the 1990s but it didn't work. This is inaccurate. Fiscal stimulus helped when Tokyo applied it, but Tokyo did so in a stop-and-go fashion. In the most notorious reverse course, Tokyo raised the consumption tax from 3 percent to 5 percent in 1997, thereby triggering its worst postwar recession until the present one. In 2009, fiscal measures succeeded in boosting consumer durables. Examples include increased car buying due to the "cash for clunkers" program, increased purchases of consumer appliances due to the "eco-points" subsidy, and more buying on weekend trips to the mall due to the temporary holiday on highway tolls.

The claim that consumers would simply save any tax cuts or increased cash handouts is belied by the data. Japanese consumption correlates best, not with pre-tax income, but after-tax income. Moreover, as noted above, household savings rates have been falling dramatically. It is true that, in the past, much of public works was wasteful "bridges to nowhere" projects and the like. However, there are plenty of needs worth spending money on. Forty percent of Japan's people live in homes without access to public sewage systems. Not only does this mean using "honey trucks" to take care of septic tanks—thereby increasing carbon emissions—but the runoff from septic tanks is a major source of water pollution.

Without monetary backup, financial markets might react to fiscal stimulus by bidding up long-term rates. The Bank of Japan can counteract this. As then-U.S. Fed Governor Ben Bernanke pointed out during a May 2003 speech in Tokyo on fighting deflation: "Consider for example a tax cut for households and businesses that is explicitly coupled with incremental Bank of Japan purchases of government debt…. [T]he government's concerns about its outstanding stock of debt are mitigated because increases in its debt are purchased by the Bank of Japan rather than sold to the private sector. Moreover, consumers and businesses should be willing to spend rather than save the bulk of their tax cut…. [This] will increase nominal spending and hence prices." (We should note that Bernanke does not agree with our view of inflation targeting; on the contrary, he proposed that these measures be coupled with price targeting.)

The Bank of Japan fears that monetization would get out of control and produce very high inflation. However, as with Bernanke's recent emergency measures in the United States, the Bank of Japan can reverse policy when it is no longer needed. The consequences of continued economic stagnation are a lot worse than the consequences of a bout of high inflation. This is like a person letting his house burn out of fear that the fire department will cause too much water damage.

CRYING WOLF ABOUT JAPANESE GOVERNMENT DEBT

Unfortunately, both the government and Bank of Japan are paralyzed by excessive fears of Japan's huge government debt. When Bank of Japan Governor Shirakawa was asked about buying more government bonds to boost the economy, he replied, "The purpose of central banks' monetary policy is to achieve sustainable economic growth under price stability, not to help fiscal financing." To avoid a collapse in government bond prices, he added, Tokyo needed to "show a path toward fiscal reconstruction and secure the trust of the markets." These fears have been exacerbated by the Greek debt crisis.

Over the past decade, we have been repeatedly told that the country was on the verge of a bond market crisis. That is simply not the case. True, Japan's gross debt now equals more than 200 percent of GDP. However, gross debt "double counts" interagency debt, one example being government bonds owned by the Bank of Japan. The correct figure is *net* debt, now at 100 percent of GDP. That's certainly worrisome. But there is no particular reason to believe that this is a magic limit. It wasn't in 1997 when Tokyo raised the consumption tax and triggered recession because net debt had reached 35 percent of GDP, nor in 2003 when financial markets panicked because net debt had reached 76 percent of GDP. Other countries have run net debt at around 100 percent of GDP for two decades without provoking crisis, among them Italy and Belgium. What raises concern is not today's level, but the ever-rising trajectory.

What distinguished Greece was not just its big government debt, but its accompaniment by a current account deficit more than 12–14 percent of GDP in recent years. When foreigners pulled out their money, crisis erupted. But Japan's debt is almost entirely funded domestically. Like Japan, Belgium has usually run a current account surplus while Italy has fluctuated between surpluses and deficits.

The key thing for sustainability is not the level of debt, but of interest payments. In fiscal 2010, net interest payments are expected to amount to less than 1.5 percent of GDP, the same level as in the 1990s. The reason is that interest rates are so much lower today. Since the Bank of Japan has the capacity to keep rates low for quite some time, Japan has plenty of breathing space to apply fiscal stimulus now and then reduce the debt-to-GDP ratio over the longer term. But there is no solution to exploding government debt without better growth.

FIGHTING ECONOMIC ANOREXIA

While fiscal-monetary stimulus is an indispensable first step, Japan needs to address why it has become such a stimulus addict. Ever since the mid-1970s, Japan has suffered from chronic "economic anorexia," an inability to consume what it produces. The main reason is low household income. As of 2008 (latest available), real per capita income from private sources (wages, income of self-employed, rent, interest, dividends, and so forth) had fallen to 63 percent of GDP, down from 68 percent in 1997.

To make up the shortfall in purchasing power, Japan has had to rely on artificial sources of demand such as chronic budget deficits to fund public works as well as tax cuts and transfer payments to companies and consumers, chronic trade surpluses, and ultra-low interest rates to stimulate private investment, much of which is excessive and wasteful. For example, even though sales at department stores have been sinking, department stores kept adding floor space. In the 2002–07 recovery, two-thirds of the entire growth in GDP was provided by a rising trade surplus and corporate investment. That's why the U.S.-originated recession hit Japan so hard.

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Consumer income lags partly because the corporate sector has been hoarding cash and became a net saver to the tune of 5 percent during 1998–2008. Even with low interest rates, firms don't have enough profitable investment outlets to use all their savings. Japan needs reforms to get the fallow cash out of the corporate sector and return it to the original providers of capital, the household sector, via higher wages, interest, and dividends.

Prime Minister Hatoyama came into office pledging to use government budgets to raise disposable household income so as to fuel consumption-led growth. Some of the proposed measures included a child allowance of ¥312,000 ($3,300) per year per child; free high school tuition at public schools and aid for students in private high schools (currently parents pay as much as $5,000 per year at public high schools for tuition and fees); cuts in highway tolls (a few-hundred-mile car trip can cost $250), and assorted tax reductions for individuals and small firms. The total in transfer payments and tax cuts was to amount to ¥21 trillion ($225 billion), or 4 percent of annual GDP, over two years. Unfortunately, the government has pulled back on some of these measures out of unwarranted fears of a government debt crisis.

Fiscal-monetary stimulus can be used either as anesthesia to ease the surgery of structural reform, or as a narcotic to dull the pain and avoid the surgery. The LDP, all too often, chose the narcotic. That's no reason for the DPJ to avoid the needed anesthesia and surgery now.

To reject both fiscal and monetary tools is to say that Japan can only wait for the rest of the world to rescue it. That's the passive mind set that has kept Japan stagnant for two decades—so far. ◆