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Looking at Policies Aimed at Ending Deflation

Policies seeking to end deflation, the most pressing issue for the Japanese economy, have been put into effect. However, there is some skepticism with regard to the effectiveness of quantitative easing in ending deflation, and significant concerns exist regarding a possible exacerbation of the latent risk of further increase in the nation's fiscal deficit. While indicating the importance of inflation targeting and aggressive monetary policy in eliminating deflationary expectations, the experts interviewed in this issue of the NIRA Policy Review point out that it will also be essential to maintain fiscal discipline and implement effective growth strategies in order to end deflation.

C O N T E N T S

A "Rocket Start" to Realizing an Exit from Deflation

Motoshige Itoh President, National Institute for Research Advancement (NIRA)

Can we do away with deflationary mindset?

Japan as a nation is entirely immersed in deflationary mindset. The university students who I teach have experienced nothing but a deflationary economy since birth. My generation experienced the spiraling prices of the 1970s and the bubble economy, but these are distant memories.

One hears opinions from every corner to the effect that even if efforts are made to achieve an exit from deflation through monetary policy, the effect will appear only temporarily, and there will be no improvement in the economy and no increase in prices. It would seem that during Japan's long period of deflation the spirit of defeat has taken root and become endemic in Japanese economic thinking.

A certain level of aggressiveness in monetary easing measures will be essential to enabling us to break out of this situation. On this point, there seems to be little disagreement among the experts interviewed for this issue.

As Professor Takeo Hoshi points out in these pages, many people believe that the Bank of Japan is the only central bank of a major nation which did not sufficiently pursue monetary easing following the global financial crisis. The current signs of correction of the extremely high yen, increases in stock prices, and correction of deflationary expectations resulting from the increased expectations towards accommodative monetary policy ushered in by the Abe administration can be seen as a process of making up for the four-and-a-half years lost since the Lehman shock.

And as Hajime Takata further indicates, the increases in stock prices and real estate prices which will result from accommodative monetary policy also have an important meaning in terms of doing away with deflationary mindset. Rather than throwing our hands up over possible over-heating of the economy or the development of a bubble when asset prices begin to increase slightly, we should remain calm and simply observe the effect that these increases have on eliminating the deflationary mindset which has become endemic in the economy.

Structural change in the Japanese economy

While ending deflation has desirable aspects for Japan, it will not be simple. One reason that the policies known as "Abenomics" have realized a strong start is that from the latter half of last year the world economy switched to a risk-on[1] posture. Capital began flowing into emerging economies, and the first signs of recovery began to appear in the stock markets and real estate markets of major nations. The U.S. economy is also on a recovery footing at present. Now is precisely the time for the Abe government to launch its "three arrows" and initiate a "rocket start" to achieving an exit from deflation.

The lack of movement in consumption and investment despite the fact that the groundwork for ending deflation has been laid clearly indicates that ending deflation will not be a simple matter. As Mr. Takata informs us, despite the fact that the private sector has accumulated a massive amount of funds as a result of the ongoing correction of balance sheets for the past 20 years, there is no inclination to undertake investments involving risk. Mr. Takata sees this as a deep-rooted lack of aggression. Precisely because of this situation, it is important to send out a strong message and eliminate deflationary mindset.

As a number of the experts interviewed in this issue point out, it will be important to ultimately achieve sustained growth through innovation and similar strategies. It will be difficult to continue by influencing expectations alone. It is essential to produce results and realize sustained growth.

Izuru Kato tells us that "unless the government continues to give the impression that it is steadily implementing medium- to long-term policy, the strands of Abenomics will begin to unravel." Further, Takashi Mitachi states that "At present market expectations are increasing, but the majority of companies have not changed their behavior. Unless they can be convinced that there is potential for long-term growth in the Japanese economy, it will be difficult to make progress in ending deflation."

Again, looking at the situation from the perspective of fiscal problems, Professor Hoshi points out that "The government needs to implement a growth strategy that places deregulation and internationalization at its center and encourage innovation in the private sector," eschewing reliance on support from government expenditure as much as possible. From the perspective of fiscal risk also, in order to end deflation while realizing sustained growth it will be important to shift demand to the private sector, and in order to do so it will be necessary to boost the potential growth rate.

What fiscal policy tools are available to us?

Leaving aside discussion of the relative merits of the policies, there is a shared awareness among the experts interviewed in this issue regarding the fiscal policy menu necessary to increasing the surety of achieving the inflation target which has been set. This menu includes increasing the amount of government bonds purchased, purchasing government bonds with longer maturity periods, purchasing higher-risk assets such as stocks and real estate-related securities, and purchasing foreign currency-denominated securities. Among these, arguments for the purchase of foreign currency-denominated securities seem to have become subdued recently. Both the government and the BOJ are sensitive to Japan's monetary easing being seen as an effort to manipulate the exchange rate. Haruhiko Kuroda, the new Governor of the BOJ, who has long experience of the world of international finance, has stated clearly that the purchase of foreign currency-denominated securities is undesirable.

Expert opinion is divided concerning whether risk assets or government bonds with longer maturities should be purchased. There are reports that BOJ Governor Kuroda is considering the active purchase of government bonds with longer maturity periods. Anticipating this direction, market interest rates have reacted to its implications, and there is a conspicuous tendency towards decline in the interest rates of long-term bonds[2].

However, thinking from the perspective of a shrinking of the swollen balance sheet of the BOJ at some stage in the future, Professor Kunio Okina points out that risk assets such as stocks and real estate-related securities are more desirable than long-term government bonds. If the BOJ takes on an enormous amount of longer-term government bonds, their sale in high volumes on the market will not be a simple matter from the perspective of bond management policy. Mr. Kato agrees with this, indicating that the selling of long-term government bonds as an exit strategy for the BOJ will be difficult in practice. In the case of risk assets, by contrast, assuming that the market is strong, sale of the assets would be relatively simple for the bank.

Professor Okina, however, contends that this "would result in excessive exposure to risk for the BOJ, [and] it would be essential for the government to accept the impairment of the bank's balance sheets, and provide support as necessary." Mr. Kato also points out that if the BOJ becomes fiscally dependent on the treasury in the event of problems appearing in its balance sheet following the purchase of risk assets, its independence will decline, and it will become unable to extricate itself from obtaining financing via treasury funds.

However, it is also true, as Professor Hoshi points out, that one aspect of aggressive monetary easing is the influencing of expectations by implementing large enough monetary easing that is hard to reverse.

The use of monetary policy alone has limitations

Having indicated that aggressive monetary policy is essential to ending deflation, it is clear that monetary policy alone is not sufficient. It is necessary to realize an ongoing expansion of demand in order to institute an upward trend in prices. In addition, the more accommodative the monetary policy, the more difficult it becomes to consider monetary policy and fiscal policy separately.

As Professor Okina stresses, it will be important to proceed with realizing fiscal soundness, and to "indicate destinations that can be reached even without financing from the BOJ." Professor Hoshi also points to the risk represented by an increase in outstanding government bonds. This sounds a warning: As we pursue aggressive monetary easing, it is also essential to consolidate fiscal expenditures as much as possible.

Mr. Mitachi and Mr. Kato stress the importance of growth strategies. Aggressive monetary easing and deficit financing are effective in realizing the present goal, exiting from deflation, in the short term, but cannot maintain this state in the long term. We must find a course by means of which the economy is able to achieve ongoing growth without excessive monetary or fiscal stimulation. Unless we promote technological innovation and boost latent growth potential, we will be incapable of presenting a vision of the future recovery of the Japanese economy.

It will no doubt take some time before the effects of growth strategies actually appear in the economy. However, it is also necessary to consider that the potential for future economic growth influences expectations. Despite the fact that it would take time for the effects to be felt in the real economy if the government moved to early implementation of effective growth strategies, such growth strategies could be expected to play an enormous role in doing away with deflationary mindset.

*1: A market state in which investors take risks and actively seek returns (profits).
*2: This essay was written in March 2013. In April 2013, the BOJ decided, at its first Monetary Policy Meeting under its new Governors, to increase the purchase of government bonds with longer maturity periods.

Motoshige Itoh:

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Expert Opinions

Exiting from Deflation: Is the Prescription Strong Enough?

We are seeing a solid beginning to efforts to exit from deflation in Japan, with the introduction of inflation targeting by the Bank of Japan and the formulation of new growth strategies by the government.
But is the policy menu sufficient to the task? And if not, what policy orientation would be desirable in the future? We sought opinions from academic economists, economists working in private enterprise, and experts at the forefront of the business world.

Interviewer: Motoshige Itoh, NIRA President

Period of interviews: February - March, 2013

Indicate post-deflation destinations for the economy

Kunio Okina
Professor, School of Government, Kyoto University

For some time now, the Bank of Japan has presented an image of the ending of deflation. If the goal is merely to hasten the achievement of this goal, several methods are available. The problem is how to return monetary policy to its original state when we have moved beyond deflation and the extraordinary monetary easing has been terminated, or when these goals are in sight. It is essential that policy should be implemented prudently, with this in mind. The extension of the maturity period for government bonds will be a danger at this time. By contrast with government bonds, the purchase of risk assets would presumably be an easy method of returning the situation to normal, because they could be sold when their prices increase. However, because this would result in excessive exposure to risk for the BOJ, it would be essential for the government to accept the impairment of the bank's balance sheets, and provide support as necessary.

In addition, while the precision of pinpointing the 2% inflation rate target is increasing, after the achievement of the target figure, it will be necessary to allow fluctuation above and below 2% within a specified range, in order not to hamper the flexibility with which monetary policy is implemented, to ensure that policy returns to normal without losing the confidence of the market.

The fact that it is becoming difficult to discuss monetary policy in isolation from fiscal policy is a serious problem. While the BOJ is engaged in its efforts, the government should indicate destinations that can be reached even without financing from the BOJ, for example the reform of the social security system and the raising of the consumption tax. We must not reach a situation in which the inflation target has been achieved but our economic and fiscal state remains poor. ■

Towards more active monetary easing

Takeo Hoshi
Professor, Stanford University

Deflation is a monetary phenomenon, and as such is a problem which can be solved by monetary policy. Given the fact that the adoption of an expansionary fiscal policy is difficult for Japan and the interest rate is already at zero, the only monetary hope is to lower the future interest rate and increase inflation expectation. However, the monetary easing by the BOJ under Governor Shirakawa was insufficient. It did not stimulate inflation expectation and also dampened the duration effect of the zero interest rate policy.

As a method of clearly communicating the goals of monetary policy to the market, inflation targeting is an excellent framework for monetary policy. But with the short term interest already at zero, it will not be easy to achieve the inflation target quickly. From this perspective, price level targeting, which would require the central bank to aim a higher inflation rate if the inflation rate falls short of the target, may be more effective than inflation targeting. Implementing large enough monetary easing that is hard to reverse would also be effective.

One potential problem of successful monetary easing is that the interest burden on government debt will increase as the nominal interest rate will increase with inflation. Japan must avoid any further worsening of its public finance. The government needs to implement a growth strategy that places deregulation and internationalization at its center and encourages innovation in the private sector. ■

A New vision: a population of 100 million and GDP per capita of 70,000 US $

Takashi Mitachi
Co-Chairman-Japan, The Boston Consulting Group K.K.;
Vice Chairman of Japan Association of Corporate Executives

The chief characteristics of Abenomics are the fact that it prioritizes influencing the market psychologically, and it adopts high-risk and high-return policies, i.e. it takes the risk of generating side effects. At present market expectations are increasing, but the majority of companies have not changed their behavior. Unless they can be convinced that there is potential for long-term growth in the Japanese economy, it will be difficult to make progress in ending deflation.

One of the fundamental causes of the stagnation in domestic investment by Japanese companies is their perception that a reduction in the scale of the economy is unavoidable given the decline in the nation's birthrate. In order to change this pessimistic outlook and halt the decline in the birthrate itself, the government should present a crystallized vision aiming towards a population of 100 million people and a GDP of 70,000 U.S. dollars per person. In addition to outlining a long-term policy to halt population decline at a population of 100 million, Japan must become a nation possessing a high degree of competitiveness in industries such as agriculture, tourism, and B2B services, like Switzerland, northern Europe and Hong Kong.

In order to realize growth strategies, it will also be important for the government to offer narratives to provide the weft for the warp of the three councils that it has organized, including the Council on Economic and Fiscal Policy. One narrative, for example, might be a consistent flow from an increase in the working population, to an increase in the female labor participation rate, the stimulation of the child-minding and educational services industries, and the reform of regulations to enable its realization. I believe that it will also be essential to continuously take on board demands for the reform of regulations and to establish bodies possessing the legal basis to make decisions, beyond the boundaries of the authorities with jurisdiction. ■

Increasing the brand power of Japanese companies

Izuru Kato
Director and Chief Economist, The Totan Research Co., Ltd.

Japan must walk a fine line as it aims to exit from deflation in order not to induce a precipitous decline in the price of government bonds. To this end, the BOJ has sought an approach which, rather than directly increasing expectations towards inflation, increases expectations of medium- to long-term growth, with the result that prices increase. However, the BOJ has failed to adequately explain its position; it is not understood by the public, and the BOJ has become a scapegoat when economic problems are thrashed out.

Cause for concern is presented by the potential for it to become difficult, in practice, to sell Japanese government bonds as an exit strategy because the major purchasers of the bonds are domestic financial institutions; for a decline in the independence of the BOJ if it becomes fiscally dependent on the treasury when it records a loss on its balance sheet; and for the BOJ to be unable to untangle itself from treasury financing.

From the perspective of eliciting the greatest psychological effect from its announcements, putting the "increase inflation to 2%" ball into play is an effective move for the BOJ. However, unless the government continues to give the impression that it is steadily implementing medium- to long-term policy, the strands of Abenomics will begin to unravel. In order to prevent this, it will be essential for Japan to accept highly-qualified migrants and to work to maintain the vigor of Japanese society as a whole. In addition to increasing their technological capacity, it will be necessary for Japanese companies to study the brand strategies of German companies and to increase their brand power and secure an adequate profit margin in order to create an environment in which wages can be readily increased. ■

Now is the perfect time to break away from the three aspects of deflationary mindset

Hajime Takata
Managing Executive Officer and Chief Economist,
Mizuho Research Institute, Ltd.

In the process of adjustment of the balance sheet which has continued for 20 years since the collapse of the bubble economy, the Japanese economy has entirely lost contact with growth scenarios and expectations of future improvement, and deleveraging, deflationary mindset, and a lack of aggression have taken root as a three-part set.

Responding to deflation is not symmetrical with responding to inflation. And fully mobilizing monetary policy and fiscal policy is necessary for responding to deflation. In this respect, the announcement of a 2% inflation target can be positively evaluated as sending a strong message.

At present, the marshaling of policy in an attempt to do away with deflationary mindset is proceeding well. In the future, it will be essential to develop growth strategies and foster expectations towards improvement in order to put the economy on a sustainable path. The ideal situation would be the realization of growth through technological innovation, but realistically the only option is to stimulate external demand by reducing the strength of the yen. The strong yen has been a factor in determining deflationary mindset since the collapse of the bubble economy, and it will be necessary to induce a sense of security to the effect that we will not immediately return to this situation. In addition, initiatives in asset markets such as stocks and real estate will be effective in continuously improving expectations for the future. If the value of assets increases, demand for funds for investment will be generated, producing a recovery in facility investments and a recovery in wages. Policies that support increases in the value of assets are demanded. With the adjustment of the U.S. balance sheet that has continued since 2007 now reaching its final phase, the upward pressure on the yen has ceased. Now is the perfect time for Abenomics to produce results. ■

What's NIRA?

The National Institute for Research Advancement (NIRA) is an independent, private-sector research institute which defines urgent policy issues and formulates bold and timely policy proposals, seeking to contribute to the revitalization and further development of Japanese society and the Japanese economy.

Utilizing a network of scholars, researchers, and specialists in a wide range of subjects, NIRA works for the public benefit from a fair and neutral perspective, attempting to reinvigorate policy debate and contribute to the process of policy formation in Japan. The institute focuses on domestic social and economic policy, international relations, and regional issues in Japan as its principal areas of research.

Established in 1974 as a government-authorized independent research institution, NIRA became an incorporated foundation in 2007, and since February 2011 has been recognized as a Public Interest Incorporated Foundation.

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