Op-Ed: Misconceptions regarding deflation and stimulus in Japan

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It is now clear that Prime Minister Shinzo Abe and the Bank of Japan (BOJ) will appeal to the magic of monetary and fiscal policy in their effort to rekindle growth in Japan's long suffering economy. This is unlikely to work and may have adverse consequences. Although framed within a more comprehensive plan of economic reform, the proposals for stimulus and inflation targeting fail to recognize the limitations inherent in economic policy tools and do not adequately reflect the myriad structural, cultural, and demographic causes of Japan's low growth.

Hasn't this been said before?

Yes; there has been excellent analysis from a micro perspective; but there has been inadequate analysis of the link between policy recommendations and macroeconomic outcomes. Misconceptions will lead to failures in public policy. For the reasons outlined below, we need to take a step back from the current discussion.

First: There is an undue focus in the public policy debate on the issue of deflation. Deflation is not an underlying cause of Japan's low growth. The focus on deflation may distract policymakers from a dispassionate analysis of the structural issues that underlie Japan's economic performance.

Second: While it would be foolish to deny the potential value of monetary and fiscal levers, there is a strong disconnect between what is being proposed and what can reasonably be achieved. Economists involved in big picture economic debates invariably fail to recognize or communicate the limitations inherent in their analysis. This is more than an academic issue. Because of our limited understanding of macro phenomena, large stimulus programs are likely to fail. The current proposals reflect a high degree of wishful thinking.

Third: If monetary and fiscal policy can be effective, it is likely that there is a very narrow range of conditions under which this will be true. Structural, cultural, and demographic factors must be consistent with the effective propagation of stimulus throughout an economy. It is highly unlikely that this is the case in Japan.

Fourth: While it is possible to construct scenarios under which Abenomics leads to long term growth and prosperity, such scenarios require unimaginably precise fine-tuning of policy over the course of many years. They assume an ideal response from the many agents that make up Japan's economy and no material external shocks.

Fifth: While it is natural to want to believe that doing something is better than doing nothing, the "something" prescribed in this case may be increasing pressure on an already fragile system. Though proponents of the current measures express awareness of the need to reign in burgeoning debt, it is profoundly difficult to see how that will actually happen.

A higher level of growth will require gradual and ongoing reform of both institutions and approaches to business; at some point an unrealistic belief in the power of fiscal and monetary tools may become self-destructive.

Let's take a look at some of these tools in the context of post-bubble Japan.

Rationale for inflation targeting

There is a near-consensus belief among economists that moderate inflation is conducive to a healthy economy. Deflation, on the other hand, may be dangerous for several reasons.

Wages are *sticky*–it is hard for companies to adjust them downward–so deflation can increase real business costs and impair planning and the allocation of capital. Deflation may also inhibit consumer spending. If consumers anticipate lower prices in the future, they may defer spending. This will be especially likely in the case of larger capital items–housing, for example, or perhaps automobiles.

There is evidence to suggest that concern over such hazards is well-founded in case of a severely deflationary environment. There is little or no evidence, however, to support an argument that challenges such as these pose a problem in an environment of mild deflation.

What has deflated in Japan?

If we examine CPI, it is more accurate to say that Japan has seen stable prices over the past 20 years than to say that Japan has experienced deflation. Since 1992, Japan's prices are materially unchanged. During this 20-year period, prices have fluctuated in a remarkably narrow band, rarely straying beyond +/- 1% in any given year. In an environment of low interest rates and stable prices, business planning should be comparatively easy. Rather than lambasting the BOJ, perhaps they are deserving of praise?

It is highly implausible that the *absence of inflation* has been a weight on Japan's economy. Yet it is widely believed that deflation has stunted growth. What gives?

Perhaps it was asset prices: Following the burst of the bubble in 1990 and for many years thereafter, equity and real estate prices fell significantly, undoubtedly putting a drag on the Japanese economy. But this should be viewed as a contributing factor, not a root cause. As concerns current policy, that horse has left the barn; asset prices have for the most part stabilized and may already be on the rise.

DEFLATION IS NOT A PRIMARY CAUSE OF JAPAN'S LOW GROWTH

There is a grave danger that the architects of the proposed stimulus policy are confusing correlation and causation in their analysis of Japan's relatively low growth. Armed with data from the past 20 years, when interest rates, inflation, and growth have all been low, politicians and economists have woven a believable narrative that deflation is a primary cause. It is not. And bankers and bureaucrats have a strange view of their omnipotence if they believe they can affect recovery through targeted stimulus. Failure to fully understand the nature of Japan's low growth will lead to improper prescriptions and may hurt the very people government claims to protect.

The factors driving deflation in Japan are a natural byproduct of demographics, culture, and the global environment.

Aging population

Japan's working age population peaked around 1995 and has dropped substantially since then. Total population hit an historical high around 2010. Barring a material change in birth rates or immigration, it will fall significantly over the coming decades.

Let me offer the following challenge: Find in history an example of an economy that has combined solid growth with a declining population. This may seem like a trick or an irrelevant question. Since at least the middle of the 19th century, the relatively more developed economies have rarely seen declining populations; instances were associated with the traumas of the First and Second World Wars.

But, a point worth contemplating is this: Modern economic theory was constructed in the West and with reference to economies having relatively youthful demographics and stable or growing populations. We have very little macro data to guide us in the case of an aging economy experiencing a decline in population. From a micro perspective, life cycle theories and insights from behavioral economics would support a view that relatively slow growth is an *inevitable and normal condition for an aging economy.*

If this is true, monetary and fiscal stimulus will be futile.

Globalization

Globalization has promoted deflationary conditions, not only in Japan but throughout the developed economies. For the past 25 years, knowledge transfers from the developed countries coupled with economic liberalization in much of the developing world have opened access to a seemingly unlimited pool of inexpensive labor. Relatively open global trading regimes coupled with advances in transportation and communications have greatly facilitated the integration of this labor into the national economies of the developed nations. The result has been deflationary for direct and indirect reasons. Due to fierce competition, prices on goods imported from developing nations—both retail goods and intermediate products—have remained low. The growth in developing economies has also kept the cost of labor in check in the post-industrialized world.

Japan is no exception to this wider pattern. The Japanese economy has benefitted from—and become dependent on—access to inexpensive foreign labor. This has contributed to Japan's stable prices.

Technology

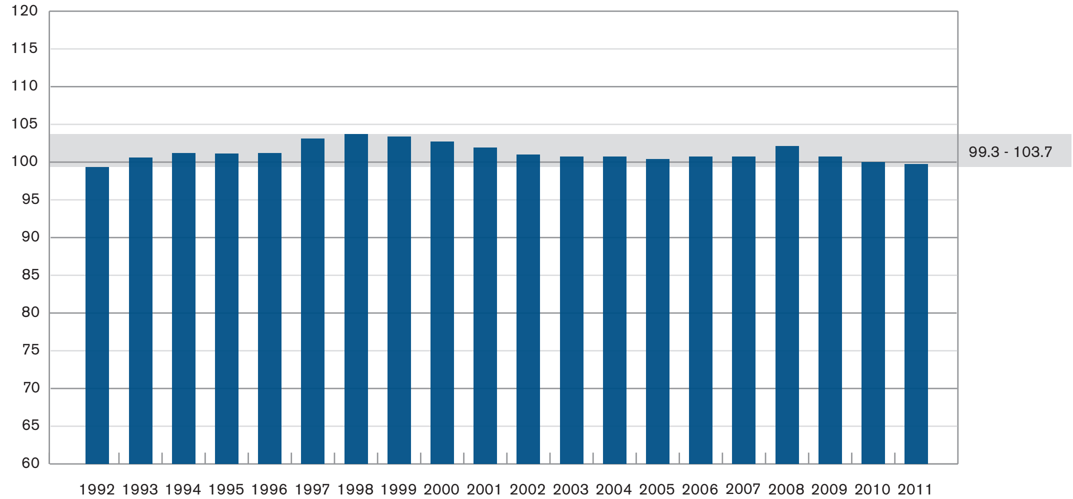
Technology has been globalization's companion in conspiring to keep prices down.

The public face of technological development has typically been a product: a phonograph, an automobile, the radio, or a television. Our age may be no different; we are in the iPod era.

But the more important aspect of technological advancement is its impact on process: on the ability to coordinate the design and delivery of goods and services across disparate cultures and geographies.

The miracle of "Japan Inc." was in large part process driven: It allowed the harnessing of vast domestic and imported resources. Since then, ongoing incorporation of technologies domestically coupled with outsourcing and offshoring has promoted price stability.

JAPAN CONSUMER PRICE INDEX, ALL ITEMS, ANNUAL AVERAGE, BASE YEAR 2010 = 100



Source: Ministry of Internal Affairs and Communications, Statistics Bureau http://www.stat.go.jp/english/data/cpi/1588.htm#his

Culture

Low growth in Japan is inseparable from a culture that values stability over growth.

No economist would object to the assertion that culture and the manifestation of culture in a nation's institutions have a material effect on economic activity. And culture is hard to change; institutions can be redesigned in a top-down manner, but culture cannot.

That pesky velocity of money

Given these complexities, it is very hard to construct an overarching theory. However, it is instructive to think about money.

Fiscal and monetary stimulus may fail due to a crash in an economist's ultimate fudge factor—velocity of money. Since the early 1990s, though velocity has not crashed in Japan, it has been continuously on the decline.

When stimulus fails, we are said to be in a liquidity trap—a surprisingly elusive concept given the ease with which it is used by economists and pundits. The term is often employed to instill fear and to empower bankers and politicians with the following implication: If you don't let us act now, we may fall into a liquidity trap and we will become mired in another Great Depression.

Before making public policy pronouncements, we should reflect on what we know and what we don't know.

WHAT DO WE KNOW?

One can say with a high degree of confidence that central bankers should take an active role in the promotion of adequate liquidity and solvency in the banking system. Clearly the central banks should support the integrity of the international payment system.

The situation with respect to coordinated monetary and fiscal stimulus is far murkier. A deeper examination of what drives the velocity of money—in particular, a better understanding of the structural and cultural factors—is needed to inform prudent policy. Velocity may be thought of as a balancing item in a clever equation or a remarkable concept that embodies the behavior of a society. If velocity is viewed as more than a balancing item, unless we can truly understanding its drivers, assertions by bankers and politicians on the impact of monetary easing and fiscal policy have little credibility.

Deflation is an easy culprit

To the extent that Japan's low growth may be viewed as abnormal, the causes will be difficult to diagnose. There is unlikely to be a simple solution.

Clearly the academics and bureaucrats who have meticulously studied modern Japan are aware of the vast complexity of the organism they are critiquing. I do not want to diminish the value of their work. It is unfortunate, however, that in the current confrontational environment, many advocates of stimulus seem overly focused on blame.

Yes, deflation is an easy culprit and an outgoing BOJ Governor is an easy target; but we should not engage in wishful thinking and we certainly should not engage in denigrating an outgoing BOJ Governor who has promoted one of Japan's cultural goals—stability—under extremely challenging circumstances.

Confusion regarding time horizons and multipliers

Japan's future does not need to be gloomy, but monetary policy is a blunt instrument. When coupled with fiscal stimulus it may be a dangerous one.

The ultimate flaw in the Prime Minister's stimulus policy—and it is tied to that pesky velocity of money—lies in the following observation: The time horizon over which stimulus might in theory work deviates dramatically from the time horizon required for necessary structural and cultural adjustments to occur in the economy. It is not by any means certain that the proposed fiscal stimulus will have a positive multiplier. And, it would seem clear that structural impediments will reduce the efficacy of stimulus.

Though economists recognize these issues, it is a curiosity that their central importance to a discussion of multipliers is not more clearly presented. Thoughtful economists at times argue over whether the multiplier associated with stimulus is positive or negative almost as if they believe there is an absolute multiplier law that is transferrable from one economy to another and one time in history to another.

Obviously this is not the case.

A stimulus at the start of 2014 is unlikely to cascade through Japan's economy over the following year if the necessary prerequisites—education, training, change in regulation, change in cultural attitudes towards employment and entrepreneurship—require many years, if not decades, to achieve.

While economists call on many data sources in their analysis of multipliers, it is remarkable how frequently we see appeals to the example of the Great Depression in the United States. In that specific situation, the multiplier associated with a well-conceived stimulus would likely have been positive. In general, in a substantially closed economy where there are idle, state-of-the-art factories and legions of idle, well-trained workers ready to run them, it is indeed quite plausible to believe that the multiplier associated with stimulus will be positive.

Is this true of Japan at the start of the 21st century? Are there cutting edge factories in Kawasaki lying idle? Is Japan's workforce trained to go back to these factories? Analogies to the Great Depression are misleading. In Japan's post-industrial service economy the cause and effect between stimulus and response will be much murkier than was likely the case in the United States 80 years ago. And, in a service economy that is integrated into a far larger global system, the effect of stimulus may be virtually impossible to project.

Can the bankers and politicians open the spigot and expect that Japan's workforce will miraculously retool itself? Will spending reduce the age of Japan's elderly? Can we truly isolate domestic from global economic effects in our analysis?

IS THERE CAUSE TO ACT NOW?

There may be times when speculative action is better than doing nothing; for example, in the context of breaking a political impasse. However, large, speculative interventions in an economy–indeed, in any complex system–are unlikely to have the impact we intend.

On many fronts, it is clear that the Prime Minister wants to project the appearance of doing something. There is a clear desire to achieve a break from a prior approach that is portrayed as excessively cautious. But how plausible is the critique of perceived past failures? If instead of promoting very low real interest rates over the past 10 years, the BOJ had ensured they were negative, and if instead of incurring a gross government debt of 200% of GDP, this ratio had been pushed to 300%, should we really believe that the Japanese economy would have rocketed forward? In the absence of significant additional change–change that may require a timescale of decades not years–this seems implausible.

The Goldilocks scenario

The Goldilocks scenario is of course the one the Prime Minister and his advisors are hoping for. Everything works out just right. Even before the stimulus begins, there is anticipation of a new era. Consumer and business optimism improves. Academics, bureaucrats, and politicians work with the business sector to reduce structural impediments. As the stimulus hits, inflation gradually emerges; consumer confidence is bolstered; economic activity revives and more than counters the possible negative effects of pending consumption tax increases. The young who have been underemployed for many years are integrated more fully into the economy; the aged have part-time employment opportunities to help cover their post-retirement expenses. Consumption and income tax revenues rise to a point where after years of deficit spending, government accounts turn positive. The BOJ masterfully keeps inflationary pressures in check, so that in spite of solid economic growth, government borrowing costs remain low, allowing debt gradually to be reduced. Social insurance promises are met with only moderate redesign. During this period, Japan's globally focused industries restructure and reinvent themselves to the point where Japan incurs a moderate but manageable trade deficit. Entrepreneurship brings life to the domestic service sector. Gradually and without disruption to the Japanese economy, foreign assets are repatriated in order to cover the cost of maintaining benefits for Japan's aged population. Birth rates continue to pick up, and 30 years from now, when Japan's baby boomers have mostly passed on, Japan has a reasonably normal looking demographic structure, a moderate debt to GDP ratio, and a vital, innovative, and prosperous economy.

It is perhaps not an impossibly optimistic narrative, at least as it regards the end point.

But can this happen without disruptions? And could it happen without a stimulus? Will the stimulus policy lead to more or less disruption in lives and livelihoods over the course of the coming decades?

The concerns that have been raised are not trivial.

National debt

The well-received and widely distributed analysis by Reinhart and Rogoff (This Time is Different)[1] would suggest that Japan already has incurred such a high level of debt that is unlikely to be repaid in full. Japan may not technically default, but will be compelled to resort to a period of rapid inflation in order to achieve a more manageable ratio of debt to real GDP.

The Prime Minister's proposed stimulus policy may in fact be leading Japan to that denouement. In any case, it seems hard to dispute the following:

(a) Japan currently has a very serious debt to GDP ratio.

(b) The larger that ratio gets, the more disruptive an adjustment will be.

This is not an hysterical assertion; it is a rather obvious fact.

Redistribution of wealth

There is a somewhat sad sentiment coursing through the current discussions–a suggestion that Japan's baby boomers helped to create the current mess and therefore must pay for the solution. Will they bear the brunt of unsound policy?

Clearly, promises made by a government must be reevaluated periodically in light of changing times. And it would be tragic if the weight of social insurance obligations to the elderly materially impaired opportunities for the young.

But any policy must achieve a balance; those who support an aggressive stimulus should be cautioned to reflect on the potential impact on the elderly:

(a) Crowding out of social insurance benefits due to the weight of growing debt

(b) Loss of value of savings due to inflation

(c) Insecurity due to increasing volatility in the economy

It does seem certain that social insurance benefits will need to be rethought. Nonetheless, economic growth will be enhanced if Japan pays close attention to the security of its aging population.

If Japan wants to stimulate domestic demand, it needs to reflect on where the money lies: substantially in the assets supporting pension obligations and in the bank deposits and insurance cash values owned by the nation's aging populace. A policy premised on the use of inflation as a means of promoting consumption may backfire when it comes to those at or nearing retirement; they may well hunker down, rather than spend.

On the other hand, domestic demand will increase if Japan's aged can be persuaded to transfer their assets to younger generations by spending rather than through death. If this is to happen, the Diet and the Central Bank should promote security rather than pursue a policy of fear.

1 Reinhart, Carmen M., & Rogoff, Kenneth S. (January, 2009). This Time is Different: http://www.reinhartandrogoff.com/

Confidence in the yen

In spite of what is perceived by many to be dismal economic performance, Japan has made a vital contribution to the stability of the global economy over the past 20 years.

Japan has helped fund America's debt and has provided capital to many emerging markets. Japan has been a constructive player in the forging of international trade and financial regimes.

Though Japan's currency is less important to trade and finance than are the dollar and the euro, faith in the yen has certainly helped to promote confidence within the global community. A debt crisis or material rise in inflation will impair that confidence and could usher in a new era of instability.

Stability of the global economy

In some sense, this is the ultimate issue: If Japan's stimulus impairs the confidence of players within the global economy, it will disrupt the trade on which Japan still dearly depends. It may increase the cost of fuel and other resources. And, a weakening global economy may impair the value of Japan's many overseas holdings.

From a geopolitical perspective, the proposed plan could weaken Japan's awkward strategic embrace with cautious East Asian neighbors.

Critics may dismiss these views as hysterical.

But, the economics of stimulus—regardless of the pronouncements of decorated economists—is not well understood. Impediments to achieving a successful result can be clearly enumerated. The adverse effects of coordinated monetary and fiscal stimulus are so potentially severe that continuation of a cautious BOJ policy is, for the time being, warranted.

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