2017.2.20

Let Us Think Important National Policies with Our Own Heads

Koji Sakuma, General Manager and Chief Economist
Institute for International Monetary Affairs

Professor Sims of Princeton University argues for the effectiveness of overcoming deflation by employing fiscal policy. It is a good thing for the Japanese to listen to various policy options, regardless of their nationality. However, they should be only opinions as a reference. The final deliberation on such an important national policy should be made with our own mind.

Since 2013, Japan has been trying to promote inflation through bold monetary easing policy. People expected the inflation should rise since the central bank's promise for promoting inflation is like declaring it will depreciate the value of the currency, but it's the achievement still only half complete. And here comes the argument that the fiscal policy can be adopted to seriously depreciate the currency value.

When the Bank of Japan came up with the untraditional quantitative-qualitative easing policy, its idea and route for ending deflation was like this. The bold monetary easing would cause a certain level of inflation while on the fiscal policy front consumption tax was going to be raised in line with the schedule prepared under the previous administration. Coupled with the social security reforms to be implemented at the same time, the market will realize the fiscal discipline would be restored in the long term.

That means, long-term interest rates will not rise so much as inflation rate. The combination of short-term monetary easing and commitment for long-term fiscal discipline would decrease the real interest rate, helping investment to recover.

Once these policies take on an assumed route, they will successfully end the deflation with mutual interaction of recovery of sound real economy and moderate inflation rate. Sound primary balance will be recovered by the increase of tax revenues through improved economic growth and tenacious reforms of social security system, which will gradually reduce the ratio of government debt outstanding to GDP over time.

However, inflation actually did not rise according to this scenario. Opinions are divided over the cause for it. One of them argues that increase of consumption tax rate or prospective policy of additional raises of its rate has deteriorated the household's confidence on the economy, hampering the realization of a steady termination of deflation. Another argues, in a reverse way, that the postponement of consumption tax rate increased uncertainty on the sustainability of social security system, driving the household, especially of younger generation, to be more conservative on consumption. Domestic investment of corporations has not increased because of stagnant domestic consumption, which is preventing the deflation from ending.

I think the latter opinion is more persuasive, but putting it aside for a while, let us assume that an active fiscal policy has succeeded in promoting inflation as Prof. Sims argues. That said, I think the future of Japan is still dark from the following two reasons.

Firstly, outright crash of fiscal credibility will certainly cause inflation. But will it be really possible to stop the inflation rate at a reasonable level, say at 2%, or 5%, or 10% at the highest? Will the inflation be stopped if the policy rate is raised?

The Japanese household has a high share of financial assets in domestic savings. Therefore if the value of their assets actually goes down, the reaction of the household will be all the more large. It may even trigger a panicky capital flight to overseas. At such a time, will the Japanese government introduce capital control measures? If it did, the credibility of Japan will instantly collapse in the international financial market. Over the last several decades after the war, Japan has accumulated the results of capital liberalization, creating the credibility for the yen that it is a convertible currency even at a crisis. So it is like throwing away that credibility. An international value of a currency reflects a comprehensive evaluation of private growth potential and governing ability of the country. Loss of fiscal credibility is like Japan by itself causing a collapse of credibility for the yen. The reputation that Japan is a country that has abandoned its responsible currency policy will weaken the Japan's voice in various fora of international society.

Secondly, inflation will surely decrease real government debts. Even so, the situation of aging society where there are less workers and more receivers of social security will be left unchanged. What we see is a temporary reduction of government debts by way of inflation without making fundamental reforms of revenue and expenditure structures. Against the reality of insufficient tax revenues and ever-growing social security burdens, the government debts will start to increase again. The speed of deterioration of the situation may be much more accelerated since the aging of population is expected to advance more rapidly.

.

Copyright 2017 Institute for International Monetary Affairs
All rights reserved. Except for brief quotations embodied in articles and reviews, no part of this publication may be reproduced in any form or by any means, including photocopy, without permission from the Institute for International Monetary Affairs.