

## ECONOMICS FOCUS

## Economics focus

**Seeking the right medicine**

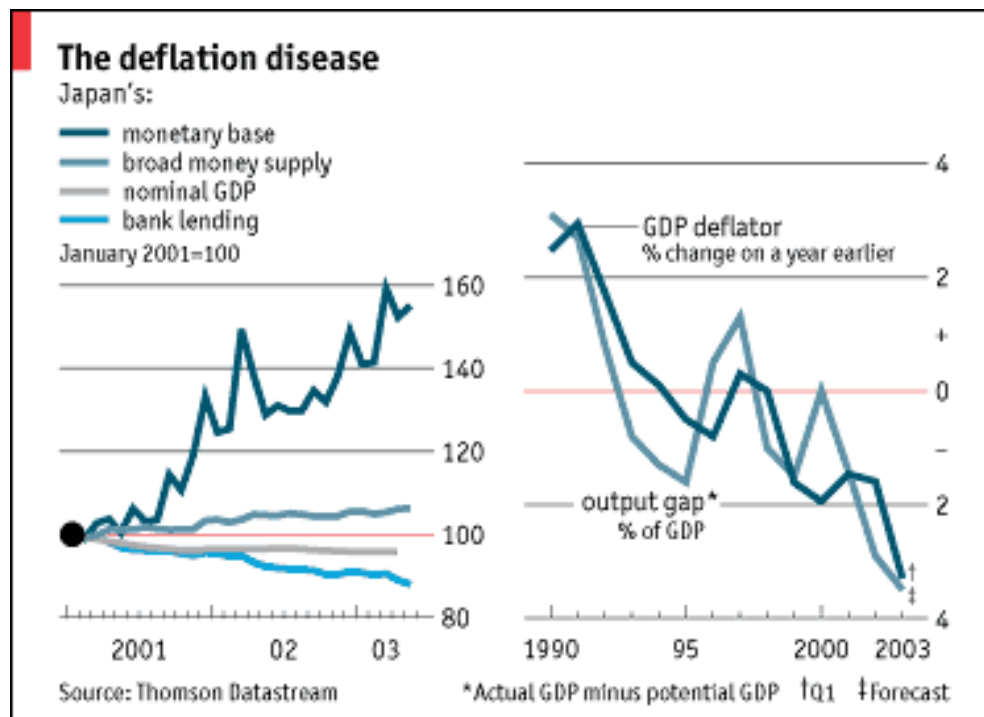
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**Japanese policymakers say they are powerless to halt deflation. They are wrong**[Get article background](#)

PRICES have been falling in Japan since 1995. Nominal GDP has shrunk by 6% since 1997. In a recent speech, Toshihiko Fukui, the new governor of the Bank of Japan, claimed that macroeconomic textbooks offer no solution to deflation. Both the Bank of Japan and the government believe that Japan's deflation is largely structural. The appropriate cure, they say, is to clean up the banking system so banks can lend again, and to close unprofitable firms to reduce excess capacity. Japan does indeed need to restructure its economy. But the real cause of deflation is insufficient demand—and the cure is macroeconomic stimulus.

The Bank of Japan insists that monetary policy does not work once interest rates hit zero. The government argues that fiscal policy has also become impotent, and there is no room for further easing because public-sector debt is already dangerously large. There is some truth in each claim. But if monetary and fiscal policies were eased in tandem they should succeed in boosting demand and stopping deflation.



Start with monetary policy. Some economists argue that all the Bank of Japan needs to do to halt deflation is to set an inflation target and keep printing money. But the bank has created lots of money by buying government bonds. The monetary base has increased at an annual rate of almost 25% over the past two years. Yet this has not fed through to broad-money growth; bank lending and nominal GDP continue to fall (see chart). The Bank of Japan blames the money-transmission mechanism: it is jammed because banks, saddled with bad loans, cannot lend more. So the priority is to fix the banking system.

However, that may not be enough. Not only are banks reluctant to lend, but overindebted firms are loth to borrow in a deflationary environment. Even if the banking system were fixed, new borrowing and hence economic growth could remain weak. Worse still, although a write-off of non-performing loans is vital in the long term, speeding it up in the short term would cause more bankruptcies and unemployment, exacerbating deflationary pressures. So how can demand be revived? The Bank of Japan is wrong to say it has done everything it can. Even if conventional "quantitative monetary easing" fails, a central bank can still try to boost private wealth and spending by buying unconventional assets, such as corporate bonds, equities and real estate. The snag is that there is huge uncertainty about the necessary size of such asset purchases and the consequent risk of future losses on the central bank's balance sheet.

As for Mr Fukui's claim that economic textbooks offer no solutions, it shows he is not an economist. Keynes pointed out 70 years ago that, when an economy is in a "liquidity trap" and monetary policy is "pushing on a string", a fiscal stimulus can boost demand. But the Ministry of Finance retorts that a huge increase in government borrowing over the past decade has failed to revive the economy. Furthermore, it says that Japan's public debt is already too big and, given the burden of an ageing population, it needs to be reduced.

## General theory time

However, Adam Posen, an economist at the Institute for International Economics in Washington, DC, has shown that fiscal policy has worked in Japan, when it has been used properly. The awkward truth is that the government has not engaged in much fiscal stimulus over the past decade. Most of the increase in government borrowing has been caused not by higher public spending, but by a slump in tax revenues on the back of a feeble economy. Even so, Japanese officials argue that there is no room for further fiscal easing. Japan's public debt stands at over 140% of GDP. If households expect future taxes to rise to service higher debt, they will save more, neutralising any stimulus.

A better way forward would be more active co-operation between monetary and fiscal policy. This has most eloquently been proposed by Ben Bernanke, a governor at America's Federal Reserve, in a recent speech in Tokyo. If the Bank of Japan were to finance tax cuts directly, this could succeed where monetary and fiscal policies pursued separately could fail. A tax cut financed by the Bank of Japan would mitigate the usual concerns about rising debt: debt purchased by the central bank rather than the private sector implies no net increase in debt service and hence no future tax increases. Consumers should then be more willing to spend rather than save any tax cut. It also gets around the Bank of Japan's concern about the blocked money-transmission mechanism: a joint monetary and fiscal boost will increase spending regardless of the health of banks.

Is it irresponsible to recommend a tax cut given the current state of Japanese public finances? Mr Bernanke suggests that the severity of the government's debt problem can be overstated, since some 59% of outstanding debt is actually held by public-sector institutions. If a money-financed fiscal expansion increases nominal GDP, while leaving government debt in private hands unchanged, this would reduce the true debt ratio. An increase in nominal GDP would also increase tax revenue, improving the government's long-term finances.

What about the Bank of Japan's worries about the health of its balance sheet if it succeeds in creating inflation, resulting in a big capital loss on its holdings of bonds? One way to fix this problem is for the Ministry of Finance to convert fixed-interest-rate government bonds held by the central bank into floating-rate bonds. That would protect the capital position of the Bank of Japan from a future rise in interest rates.

Ending deflation will not solve all of Japan's problems. But it would make it easier to carry out banking and structural reform, by reducing the job losses and financial distress caused by restructuring. Unfortunately, the chances of co-operation between the government and the central bank are low. And the Ministry of Finance is more interested in raising taxes than in cutting them. Expect deflation to persist.