American Enterprise Institute for Public Policy Research

Economic Outlook

March 2012

Is Japan Set to Boom?

By John H. Makin

Japan's economic growth has been stagnant since 1990 in what have been called its two "lost decades." The significant contractions in gross national product and gross domestic product during the fourth quarter of 2011 tell the same story: a Japan trapped in a cycle of weak growth and deflation. However, the Bank of Japan announced last month that it would finally begin to buy bonds, increasing the money supply in pursuit of an inflation target of 1 percent. This shift to expansionary monetary policy signals the first time in more than two decades when the Bank of Japan has been able to overcome its fear of inflation. Carefully managed, this policy could spur both Japan's economy and the corresponding world output that would result from a robust Japan. The experiment's success will be key to world economic growth in the coming decade.

After many years of false starts, the Japanese economy may finally be set to boom—or at least to enter a period of sustained growth with a sharply rising stock market. Many will have their doubts, especially in view of the recent weak performance of the Japanese economy I will outline. But for the first time in decades, the Bank of Japan (BOJ) is finally undertaking some innovative measures that may lead to real gross domestic product (GDP) growth in Japan. Based on these promising signs, the hope is that a surge in Japanese growth would be a big boost to Japanese stocks and to the global economy.

The Japanese economy is not in good shape. In its most recent report on gross national product (GNP), the Japanese government announced a nasty 2.3 percent annual rate of contraction in the economy during the fourth quarter of 2011. Nominal GDP growth was even weaker, contracting at a 3 percent annual rate, thanks to a falling price level at about a 1 percent deflation rate. To put the same sad story even more clearly, the current yen value of Japan's GNP stood at about ¥470 trillion at the end of 2011, about the same as in 2009 and well below the ¥515 trillion in 2007. With Japan's economy entering what could be its third "lost decade" of weak or negative growth and falling prices, a decisive policy response is required.

John H. Makin (jmakin@aei.org) is a resident scholar at AEI.

The Bank of Japan Changes Course

Throughout most of Japan's two lost decades (1990–2010), the BOJ has played defense. Well

Key points in this *Outlook*:

- Japan has suffered two "lost decades" of stagnant growth, but new quantitative easing by the Bank of Japan may finally resuscitate the country's economy.
- Though reflation is not an ideal course, if Japan allows deflation to persist, its massive debt burden will grow as its economy shrinks and its currency depreciates.
- Japan's experiment could provide lessons on the effects of quantitative easing for other nations and may offset weak outlooks in the United States and Europe.

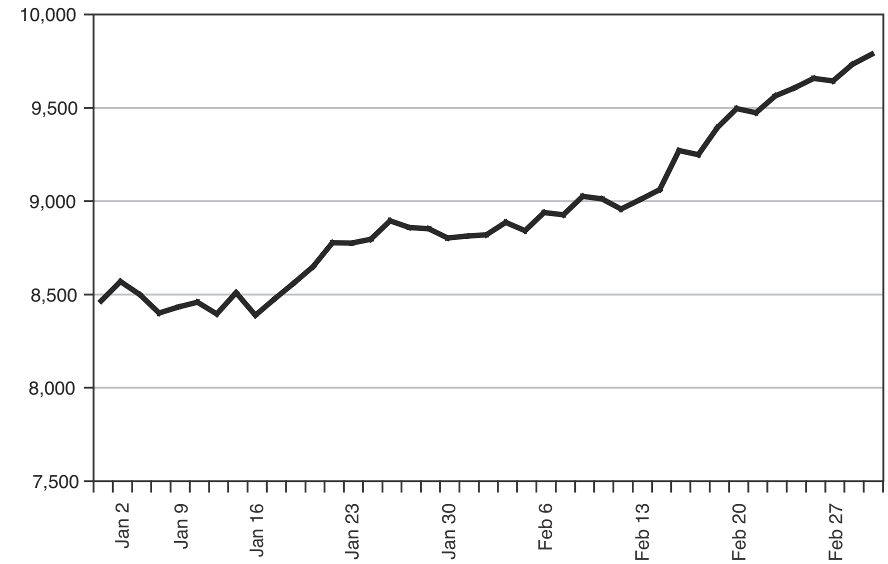
after the economy's sharp dive following an ill-advised 1997 tax increase, it did push short-term interest rates to zero. But it remained cautious about quantitative easing, a term that describes direct purchases of government bonds. When it did engage in quantitative easing after 2000, the BOJ was careful to say that it was concerned about inflation and would withdraw stimulus given any sign of rising prices.

But the BOJ changed its stance abruptly on February 14 of this year. Faced with persistent yen strength, a sharp drop in exports, fears of a weaker global economy, and aggressive extra easing moves by the Fed and the European Central Bank (ECB), the BOJ announced a sharp rise in the level of government bonds (JGBs) that it would purchase and set an explicit inflation target of 1 percent with none of its usual caveats or reservations about its fear of runaway inflation.

The BOJ was also responding to rising pressure from a Japanese government that has been growing increasingly dissatisfied with an economy stuck in the deflationary low- or no-growth doldrums for many years. This new program, along with existing bond purchase programs (called Rinban), means that BOJ will purchase nearly all new JGBs issued for the rest of 2012. In short, the BOJ is committed to printing money to finance government spending and interest payments on its huge outstanding debt (over 200 percent of GDP) for the balance of this year.

FIGURE 1

NIKKEI 225 STOCK INDEX, 2012 CLOSE PRICES



SOURCE: Nihon Keizai Shinbun.

FIGURE 2

DOLLAR-YEN EXCHANGE RATE (DOLLARS PER HUNDRED YEN)

SOURCE: Thomson Reuters.

The market response to the BOJ's new and more intense reflation initiative has been favorable and impressive. Japan's stock market index, the Nikkei, has risen by 8 percent since the February 14 announcement, bringing it to its highest level since July 2011. (See figure 1.) And the yen has weakened against other currencies—by 3.5 percent against the US dollar and by 5.6 percent against the euro—representing its lowest level since last July. (See figures 2 and 3.) The weaker yen means that Japan's exports may reverse their recent sharp drop, thereby improving the outlook for Japan's traded-goods sector, while a boost to equity prices would help household balance sheets and may spur increased consumption, helping Japan's domestic companies.

More broadly, stock and currency markets are suggesting that although the easing steps taken by the Bank of

Japan have mostly gone unnoticed, they may be just as significant as the ECB's January move to offer three-year guaranteed refinancing facilities to European banks; they are perhaps even more significant than the US Federal Reserve's January hint about keeping rates close to zero for another two years at least. Proactive steps by the BOJ to overcome persistent deflation are nearly twenty years overdue and so come as a surprise, which boosts their potential effectiveness. Once markets notice and absorb the full significance of the BOJ's new initiative, Japan's stock market could finally become a world beater.

FIGURE 3

EURO-YEN EXCHANGE RATE (EUROS PER HUNDRED YEN)

SOURCE: Thomson Reuters.

Potential Side Effects of Japan's Expansionary Monetary Policy

How Japan's government bond market responds to the Bank of Japan"s new inflationary initiative will be critical in determining its ultimate success or failure. It will also hold lessons for other nations' possible experiences with quantitative easing. The initial response has been benign, with interest rates on ten-year government bonds dropping a few basis points, from about 1 percent to 0.96 percent. The bonds were buoyed by the BOJ's commitment to buy an extra ¥10 trillion's worth.

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In the past, one of the BOJ's concerns about reflation policy has been a possible sharp rise in inflation expectations that would undermine the expected future purchasing power of the yen and cause lenders to demand higher interest rates on government bonds. Given that Japan's government debt is more than twice its GDP, higher interest rates would sharply boost borrowing costs on new debt.

Fortunately, two other important changes would accompany higher inflation expectations that would help to mitigate the burden of an eventual rise in interest rates. First, the desire to hold cash and low-yielding debt would drop and lenders would spend more, especially on durable goods for which they expect prices to rise. Investors would sell cash and low-yielding bonds in exchange for stocks as they begin to expect higher dividends from companies prospering in a faster-growing economy with more consumption spending and exports. Second, faster growth would generate more tax revenues, helping defray the government's higher borrowing costs.

This all amounts to saying that the eventual normalization of interest rates to, for example, 3 percent on ten-year government bonds indicates a broader normalization in the Japanese economy that includes stable prices, higher growth and employment, and an end to chronic overvaluation of the yen. All major industrial economies go through this process after a financial crisis; it just does not usually get delayed for twenty years, during which stagnation prevails. But Japan's politicians are an unusually ineffective lot, and the BOJ has been hampered by an almost obsessive fear of inflation that has led it to tolerate deflation for far too long.

The BOJ still insists it cannot control inflation, but history shows that if it promises to keep printing money until inflation reaches 1 percent, it will achieve that goal. Interest rates will rise, but the requisite level of government borrowing will fall as faster growth boosts revenues and cuts budget deficits.

The losers in the reflation process will be holders of government debt with low-interest coupons, like the 1 percent on ten-year JGBs. These investors will see the face value of their bonds drop given the existence of a new JGB that pays an interest rate like 3 percent. Holders of shorter-term securities will suffer less, and even long-term bondholders will see their bonds eventually redeemed at par value at maturity, with no nominal loss of principal.

The real loss will be tied to the reduced purchasing power of interest payments on the outstanding longer-term bonds. The holder of a ten-year bond issued two years ago with a 1 percent coupon will be stuck with interest earnings over eight years that are worth considerably less than those enjoyed by an owner of a new ten-year bond with a 3 percent coupon. In effect, bondholders will have been taxed by the reflationary policy. That said, other taxes would be required to reduce deficits, and they would reduce growth rather than enhance it as reflationary policy would do.

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Managing Inflation Targets

In addition to the effective tax on bondholders, reflation has pitfalls that can undo its benefits. Indeed, some view such pitfalls as serious enough to rule out the use of reflationary measures. The root of the problem lies with the stickiness and unpredictability of inflationary expectations. If the aim of reflation is to boost the inflation rate from negative 1 percent to positive 1 percent, as the BOJ is attempting to do, how does it avoid overshooting the target?

Suppose printing money initially has no impact on inflation expectations, as has usually been the case, especially if deflation has been firmly entrenched for over a decade as in Japan. Under those circumstances, the central bank keeps printing money, and growth rises smartly while the exchange rate and the unemployment rate fall, stock prices rise, and interest rates remain steady. Money printing is, at first, remarkably successful, and the central bank keeps pursuing its goal of 1 percent inflation. Then, in an environment of rising prosperity, prices and interest rates start to rise along with stocks and employment, while the currency starts to lose value. Expected deflation turns to expected inflation.

The transition away from expected deflation must be controlled so that only modest expected inflation occurs. The process is well known, and guided by clear market signals. The combination of higher interest rates and continued currency weakness is a sure sign of rising inflation expectations. When higher real growth expectations boost interest rates, the currency should strengthen (controlling for events in other countries). But once money printing leads to higher inflation expectations without boosting growth, the money printing should stop. Simultaneously, the central bank could signal clearly that it has achieved its goal of ending deflation, reiterate its 1 percent inflation target, and promise to make future adjustments in the form of faster or slower money growth should actual inflation turn out to be lower or higher than 1 percent.

The process of moving to an inflation target is, in short, an iterative one. No central bank would claim that it could hit an inflation target on the first try. Rather, most claim that they will watch market signals and keep gradually adjusting to get closer to their target inflation rate.

The commitment to adjustments must be firm and symmetric. As markets signal an overshoot of the inflation rate, the central bank must slow money printing without any concession to the possible feared negative impact on any positive market conditions such as a booming stock market and a drop in unemployment. Critics of reflation claim (with considerable supporting evidence, including the Alan Greenspan Fed's highly accommodative stance prior to the 2007–08 bubble) that central banks cannot resist the pressure to keep the recovery party going.

The antidote to this problem is for the central bank to clearly announce a policy that commits it to consistently iterating toward a preannounced low inflation target. The more unpopular the first iteration of tighter policy is in response to an overshoot, the better. The alternative is a pattern of constant accommodation of risk markets that ends in tears as we saw in the United States in 2008, as well as in Europe in 2011 and Japan in 1990.

The BOJ's recent decision to print money in pursuit of ending deflation and achieving a modest positive inflation rate is among the most important monetary policy experiments of the post–World War II period. It is unique because it starts in a time of persistent deflation and a chronically overvalued currency that has produced more than two lost decades of low growth and stagnation. Japan is also in a "debt trap" insofar as its stock of government debt is more than twice its GDP and well over twice the level labeled as crisis-inducing in the famous investigation of financial crises by Carmen Reinhart and Kenneth Rogoff.[1]

That said, Japan is almost in a "nothing left to lose" situation: if it allows deflation to persist, the burden of its massive debt will only grow while its demand-starved economy continues to shrink and its battle against chronic deflationary currency appreciation becomes even more difficult. (Recall last fall's largely unsuccessful, massive intervention by Japan to try and push its currency down; the recent money-printing exercise has been for more successful because it represents a fundamental change in policy.)

With the US recovery tepid and Europe slipping into a recession while China is trying, with varying degrees of success, to achieve a smooth landing, it surely would be a pleasant surprise to see a robust recovery in Japan even though it is now "only" the world's third largest economy. Some will grumble about Japan "beggaring its neighbors" by weakening its currency, but a weaker yen is a small price to pay for a faster-growing Japanese economy. It would be silly to fight over the division of a bigger global output pie that would result from faster growth in Japan.

One must hope that the BOJ knows what is at stake, for both its own economy and the global economy, not to mention the somewhat tattered reputation of central banks in the post-crisis era. Engineering a successful transition out of deflation is one of the most challenging aspects of monetary policy, but the BOJ just might be able to do it this time.

Note

1. Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a Time of Debt" (working paper #15639, National Bureau of Economic Research, January 2010), www.nber.org/papers/w15639 (accessed February 29, 2012).