Japan needs more aggression in warding off deflation

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By Kumiharu Shigehara

Japan's economic expansion stumbled by late 2007, and in the context of the global economic crisis, it has been trapped in the deepest recession of the post-war era. Initially, the impact of the global crisis on the Japanese economy was expected to be limited because Japanese banks and other financial institutions were relatively insulated from financial turmoil. However, between the third quarter of 2008 and the first quarter of this year, Japan's exports fell at an annual rate of some 55 per cent in volume terms, the sharpest among OECD countries and double the area's average rate of decline. While exports have rebounded since then, the IMF projects a decline in Japan's net exports for this year as a whole, resulting in a negative contribution of 2.4 per cent to real gross domestic product growth. As a result of this and a sharp drop in domestic demand, real GDP this year is projected to decline by 5.4 per cent.

On the other hand, for the US, the epicentre of the global financial crisis, the IMF projects its net exports to make a positive 1.2 per cent contribution to real GDP growth this year, the same amount as for last year. Thus, despite a sharp contraction of domestic demand, the decline in US GDP is forecast to be limited to 2.7 per cent, just a half of output decline projected for Japan. For the UK, another epicentre of the financial crisis, the IMF projects net exports to make a positive 0.8 per cent contribution to real GDP growth this year, after a positive 0.4 per cent contribution last year, thus limiting a contraction of UK real GDP to 4.4 per cent. While the IMF expects a negative output contribution of net exports for the euro area this year, it is forecast to amount to 0.8 per cent of GDP, just one third of the equivalent number for Japan.

For the ten-year period of 2000-09 as a whole, the contribution of net exports to real GDP growth in Japan is most likely to average just 0.1 per cent at an annual rate while real GDP growth is forecast to average 0.6 per cent at an annual rate, according to the OECD Economic Outlook 85 database. Japan will thus most likely enter into the second decade of this century as an OECD country which has, at least, not worsened global imbalances.

In passing, let us note that the contribution of Japan's net exports to real GDP growth was 0.3 per cent at an average annual rate in the 1980s and 0.1 per cent in the 1990s.

Note also that the equivalent numbers for the ten-year period of 2000-09 are for Germany 0.4 per cent point, 1.3 per cent for China and just 1 per cent point for Korea. It is also important to note that even with no changes in net export volumes, Japan's huge foreign investment income helps to maintain its current account position in surplus, unless oil and other primary commodity price hikes and other terms of trade changes inflate Japan's external payments in dollar terms.

An important reason for a sharp decline in Japan's export volumes is the yen's sharp rise since 2007. The rise of the Japanese yen between 2007 and 2009, based on the assumption that exchange rates for the second half of this year will remain at mid-2009 levels, amounts to 18.9 per cent against the US dollar and to 25.1 per cent in effective terms. The yen's sharper advance in effective terms than against the US dollar reflects the declines of currencies of the UK, Korea and emerging economies in Asia and Latin America over this period as a whole. On top of this, the yen has advanced further over recent weeks.

These currency movements will exert unwelcome deflationary pressure on the Japanese economy basically through four channels.

First, weaker exports demand will widen the output gap. Second, a further decline in import prices will accelerate consumer price deflation. Third, international cost comparison against Japan will encourage a further shift of production bases abroad by Japanese producers, aggravating business fixed investment and reducing employment at home. Fourth, those firms maintaining production bases at home will be forced to cut wages and other costs even more to cope with a further loss of international price competitiveness associated with the yen's sharper rise. Lower consumer prices will moderate the decline in real wages relative to nominal wages. Nevertheless, real wage cuts, together with reduced employment, will lower household income and consumption in real terms in a situation where Japan's personal saving rate has already been reduced to about 3 per cent, somewhat lower than current US and UK levels and far below Germany's rate.

With a zero bound on nominal interest rates, intensified deflation will further increase real interest rates and weaken credit demand even more, thus entailing a deflation spiral. How does the Bank of Japan intend to deal with this difficult situation? No clue can be found in the Bank's published materials. Lack of information about the way the Bank would deal with further upward pressure on the yen appears to have weakened central bank credibility and increased market uncertainty and volatility.

In this context, it is interesting to look at Canada's experiment. In its monetary policy report published last July, the Bank of Canada stated "a stronger and more volatile Canadian dollar could act as a significant drag on growth and put additional downward pressure on inflation for Canada", giving an indication about the level of the Canadian dollar beyond which the Bank does not like to see it rise. Note that this statement was made when the Canadian dollar was fairly stable around a rate of one CN$ = 0.80 US$, some 20 per cent lower than a year earlier. The statement was preceded by the Bank of Canada's decision, announced last April, to make a conditional commitment to hold the central bank policy rate at 0.25 per cent until the second quarter of 2010. In the monetary policy report published in that month, the Bank outlined a framework describing unconventional measures it could employ, if needed, and principles that would govern the use of those tools.

Another interesting experiment is found in Sweden. In July its central bank lowered the interest rate on its one-week deposit facility to -0.25 per cent at the same time that it squeezed its benchmark lending rate down to 0.25 per cent. The actual amount left in that account appears to be far smaller than the overnight deposit facility on which it pays a 0.15 per cent interest rate. Nevertheless, the Swedish central bank has embraced a policy that the Bank of Japan could use to deal with deflationary pressure.

This brief review of experiments by some central banks abroad suggests that the Bank of Japan can use a greater variety of unconventional policy instruments than currently in use in Japan in a situation where its policy rate is as low as 0.1 per cent. Indeed, the Bank must adopt a more aggressive policy stance in warding off deflation.

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1. This is a fascinating article, probably the most revealing and comprehensive I have read in the realm of international finance. Japan is certainly in a precarious state. My only hope is that as the US economy, as well as some in South America and Europe begin to recover, investment flows to those countries will appreciate their currencies relative to the Japanese yen, augmenting the demand for Japanese products/exports. The question is whether Japan can sustain itself until this transpires, perhaps another two quarters or so. Maybe Japan will be ensconced from total ruin with its vast foreign currency reserves. Some unconventional monetary policy tools, such as the negative interest rate, can help facilitate some improvement. Japan needs to get creative and perhaps it should elicit the help of other central banks around the world.

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