Ifo Viewpoint

Ifo Viewpoint No. 26: The Japanese Disease

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Long gone is the era of the Japanese economic miracle. During the past ten years, the Japanese economy, which used to be the model pupil of the West, fell 20% below the world-wide growth trend. Whereas the Asian NIEs seem to have recovered from the 1998 crisis, Japan is just bumping along. In 2000, real GDP growth amounted to a mere 1.7%, and prices fell for the first time. In 2001, a deflation of 0.7% is expected, which - given the insufficient inclusion of quality improvements in the price statistics - may in fact amount to a 1.5 % reduction of the price level. This makes Japan the only OECD country to record deflation.

The new government of Prime Minister Koizumi plans to solve the problem with structural reforms. However, as important as these reforms are, deflation is a macroeconomic problem which can only be solved with macroeconomic means. Supply policy is not needed when demand is lacking, notwithstanding the measures addressing the loans which have turned non-performing due to deflation.

The problem is excessive saving by private households and insufficient investment by business. Paradoxically, Japanese firms have even become net savers. Unlike firms in other countries, they are not demanders of the private households' savings in order to finance their investment, but are themselves providers of savings to the financial markets. According to the IMF, in 2000, the private sector as a whole, i.e. firms and households together, had savings in excess of investment in the amount of 9.3% of Japanese GDP. That is a most unusual relationship. In the EU the private sector even invests somewhat more than it saves.

While Japanese excess savings flow partially into capital exports, most - to the tune of 8.2% of GDP - go to finance government deficit spending.

And that is the problem. The Japanese economy is apparently in a situation close to what Alvin Hansen called "secular stagnation". Large scale investment, fed by the high savings of an ageing society making provisions for old age, have created an ample capital stock and a corresponding low marginal productivity of capital. Thus it becomes increasingly difficult to invest productively the permanent inflow of new savings, with the result that the state had to create the corresponding investment opportunities. The Japanese savers are accumulating claims against the Japanese tax payers because private investors refuse to become debtors.

Hansen called the excess of planned saving over planned investment "the deflationary gap", because it implies a lack of aggregate demand. The government can close the gap by incurring more and more debt. But the ability of continuing this policy year after year diminishes as it creates a confidence crisis of the investors with unforeseeable consequences for the state. In 1992, Japanese debt amounted to 60% of GDP. Only eight years later it was in excess of 130%, and still the debt carousel keeps turning. In the whole of Europe there is no single country with a comparable debt ratio. Even Belgium and Italy with debt ratios of 104% and 106%, respectively, have been superseded by Japan.

Whenever deficit financing becomes difficult, an expansionary monetary policy is the obvious choice in order to lower interest rates and in this way give an incentive to firms to make the necessary investment. Unfortunately, this road is also blocked with short-term interest rates already close to zero. Japan finds itself, as Paul Krugman has noted, in the Keynesian liquidity trap. For decades the liquidity trap described by Keynes remained in the textbooks without having ever been observed anywhere. Today, when it has been erased from most textbooks, it shows up in the real world.

An economy in the liquidity trap cannot be revived by monetary policy, because monetary policy would have to cut interest rates; but it is impossible to make nominal interest rates negative. Everybody would prefer to hoard his money instead of lending it at negative interest rates.

There is, however, a trick to further lower real interest rates at least, a trick pointed out back in 1991 by Larry Summers, later to become U.S. treasury secretary: You have to try to get business used to an inflation trend before the crisis strikes. If prices always rise, monetary policy can lower real interest rates below zero, and perhaps low enough to get the economy in recession moving again. The Japanese would be better off today if they had inflation. But once you are in a liquidity trap, it is hardly possible to create inflation, at least not with monetary policy.

The only real option remaining open to Japan is to devalue its currency. The Bank of Japan can produce a devaluation any time by printing additional yen and selling them for dollars in the foreign exchange markets. Devaluation strengthens foreign demand and thus directly helps the economy. Indirectly it helps by making possible the creation of an inflationary trend and thus providing the central bank, during a temporary recession, with the means of a negative real interest rate in order to revive investment.

There remains, however, the problem that even under the new government, the Japanese savers have a structural majority in parliament. The new Prime Minister represents the Liberal Democrats, and those backing this party benefit from deflation as it adds to

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today and will be even more so in the future, as the rapidly ageing population tends to increase the political weight of the savers. Japan is in an economic and political trap from which it may only free itself by radical political change.

The Japanese disease must be taken seriously in Europe, especially in Germany, for Germany also has ample capital and is confronted with the increasing problems of an ageing population. Although in Germany savings are lower due to the generous social security system, Germans more than any other people are still sensitive to the experience of past inflation. Furthermore, if the necessity ever occurred, devaluation of the national currency would no longer be an available policy choice.

The Japanese example has shown that it is not only inflation which poses a risk but also the pursuit of too rigorous a policy of price stability. An appropriate balancing of both risks neither takes place in Germany nor anywhere else in Europe. In view of the Japanese situation, the fact that price stability is the only obligatory objective of the European Central Bank can only be noted with apprehension.

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