

Japan's Decade Long Tryst with Deflation : What Led a Prospering Economy into a Deflationary Spiral?

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Abstract

Japan suffered a deflationary hangover from the great episodic Yen appreciations during the late 1980s into the mid-1990s. The country's GDP stagnated at low levels during the lost decade, and inflation was persistently low. The period beginning early 1991 and extending to 2001 is popularly referred to as Japan's lost decade, characterized by deflation. The government's remedial measure – an expansionary fiscal policy failed to boost the economy. Using the macroeconomic concepts of fiscal policy, monetary policy, and IS-LM model, this note elucidated why an expansionary fiscal policy failed in Japan, despite having the potential to succeed. The analysis also highlighted the impertinence of a credit crunch in the monetary sector on the economic crisis.

Keywords : Japan, deflation, expansionary fiscal policy, output gap, macroeconomics

JEL Classification Codes : E6, E7, H3

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This short note aims to study the reasons that led to an average output gap of around 4% in Japan during the 10 years of its deflationary spiral. Japan was a growing economy with a consistently increasing GDP and immense potential. However, the late 1990s turned this around. This article aims to provide an analysis of the primary causes, their macroeconomic impact, the measures undertaken by the Japanese government to counter this evil and why they failed, and a few potential measures which could have abated the negative impact.

The Japanese economy flourished during the Great Depression of the 1930s. After experiencing persistent deflation till 1932, it experienced robust economic growth and mild inflation for many years, despite other nations grappling with the Great Depression. However, this golden trajectory soon dovetailed as an outcome of the Plaza Accord of 1985. The Plaza Accord was a 1985 agreement among the G-5 nations — France, Germany, the United States, the United Kingdom, and Japan to manipulate exchange rates by depreciating the U.S. dollar relative to the Japanese yen and the German deutsche mark. Appreciation of the yen, which is an increase in its purchasing power relative to the USD, led to a major short-term shock to Japanese export-based industries as exports became expensive. To offset this, the Japanese government embarked on a massive unregulated macroeconomic stimulus involving an expansionary monetary (reducing interest rates to stimulate borrowings) and fiscal policy (subsidy packages) to incentivize its export industries which were losing the momentum to continue production. This Quantitative Easing and Expansionary Fiscal Policy created equally massive credit and asset price bubbles in Japan's financial and real estate markets through the late 1980s. Between 1986 and early 1990, the prices of land, property, equities, and bonds rose at an accelerating pace. The slow response of the

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Bank of Japan to intervene in the marketplace by suddenly increasing the discount rate to tighten its monetary policy in a bid to control the asset price boom exacerbated the problem. It was in 1990 when the bubble burst, and the stock market plummeted to 21,000 points. This was the impetus to Japan's deflationary spiral.

The asset price bubble burst severely impacted consumer confidence due to a sharp dip in real household income. Citizens started saving more and spending less, and the aggregate demand in the economy decreased. A decrease in aggregate demand had a negative impact on the price of consumer goods, and firms were discouraged to produce output. As a result, unemployment increased, and income and output further decreased. Adding to this dilemma was the rapidly aging population of Japan with a higher MPS. Deflationary expectations looming in the economy made consumers postpone consumption expenditure and caused the credit crunch in the monetary sector. Balance sheets of banks were covered with NPAs, which were pledged as collateral during the asset price boom. To counter deflation, Japan first followed the Keynesian textbook : Boost aggregate demand. It increased government expenditure on public works to stimulate demand in the economy. However, this did not work as these measures were not executed well — money was wasted on inefficient public works projects and given to failing businesses. This wasteful expenditure of the government led to unsustainable government debt of 140%. The government raised consumption tax to 5% to remove this deficit, which we believe was an incorrect decision as Japan's population consists of majorly aging citizens who have a higher MPS than MPC. An increase in taxes reduced the disposable income of people, thereby further reducing their consumption expenditure, reducing aggregate demand, income, and output. Thus, tax revenues could not offset this deficit, which decreased automatically due to a contraction in output. An expansionary fiscal policy would have worked well in Japan because Japan is relatively closed to international trade and capital. Imports account for only 10% of GDP, the lowest proportion in any OECD country, and capital is still not fully mobile: Japanese savers remain reluctant to move their money abroad in search of higher returns. This captive pool of saving makes it easier to finance debt without pushing up interest rates. This could not be capitalized either as Japan was entering a liquidity trap due to consistently falling interest rates in the late 1980s. The interest rates were 0.5% for much of the 1990s, but these failed to stimulate the Japanese economy, and deflation persisted as the economy had entered a liquidity trap.

Implications of the Policies Adopted by Japan to Salvage Its Failing Economy

- ✧ The initial macroeconomic stimulus in fiscal and monetary terms to counter the negative impacts of the appreciating yen led to a massive asset price bubble in Japan, the growth of which was not nipped at the bud by the Japanese central bank. When this bubble burst, the deflationary spiral commenced.
- ✧ A subsequent fiscal stimulus to boost aggregate demand also did not work as a remedial measure since the investments were made in failing businesses and inefficient public works, leading to a considerable increase in the output gap.
- ✧ An increase in the consumption tax rate to bridge the deficit aggravated the deflationary pressures since Japan has a 'silver tsunami,' which leads to anti-consumerism.
- ✧ The persistently low interest rates also led to a liquidity trap in Japan.
- ✧ An expansionary fiscal policy works effectively in a liquidity trap as it increases aggregate demand, shifting the IS curve to the right, with no impact on the interest rates, causing the income and output to increase full multiplier times as a consequence of zero crowding out. However, this too failed in Japan because deflation had caused current aggregate demand to fall, and since these pressures persisted, people continued postponing purchases.
- ✧ Since the government started running deficits, expectations of increasing direct taxes made people spend less and save more. The aging population added to this dilemma.

Conclusion

Here are my observations and understanding of this deflationary spiral. Along with a liquidity trap, Japan was experiencing a credit crunch due to a backlog of NPAs, an outcome of the asset price bubble burst. However, I share my opinion with Paul Krugman that a credit crunch does not act as a contributing factor to worsen the situation. Any potential increase in the lending activity by banks by running down their reserves would not revive the economy as manufacturers would be unwilling to borrow due to the general gloom in the economy and the downswing in the business activity being experienced. If they did borrow, they would have incurred losses as interest being a fixed obligation would have to be paid, irrespective of the losses they would have incurred due to declining prices. The underlying problem from which everything stemmed was the inability of the government to clean up the banking system. Banks kept rolling over bad loans rather than writing them off. This sustained overcapacity as unprofitable firms were kept alive and resources were locked in low-return sectors.

Immediate measures (structural reforms) which could have improved the situation are NPAs write-offs and bank recapitalization. A loan write-off sets free the money parked by the banks for the provisioning of any loan. Bank recapitalization involves infusing more capital in state-run banks to meet the capital adequacy norms through government-issued recapitalization bonds, which also helps the government maintain its fiscal deficit target as no money directly goes out from its coffers. These measures would have increased consumer confidence as instead of hoarding savings, these would have been deposited. Banks could have extended more loans and created credit while maintaining reasonable interest rates, leading to a potential spurt in investment and an increase in output, thereby reducing the output gap.

Author's Contribution

This short communication has been conceived and written by Sasha Sharma, the sole author. She undertook all the research and readings to develop this original piece of work. The author studied the works of Paul Krugman and some Austrian economists. The observations and suggestions are the personal views of the author.

Conflict of Interest

The author certifies that she has no affiliations with or involvement in any organization or entity with any financial interest or non-financial interest in the subject matter or materials discussed in this manuscript.

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