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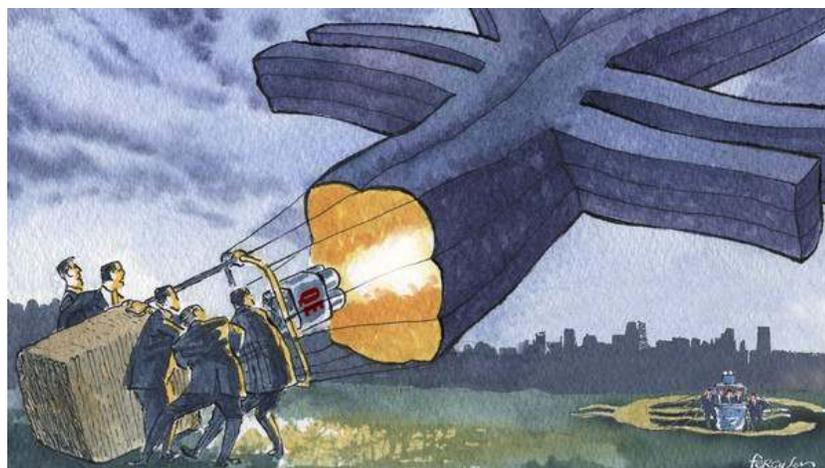
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Warnings from Japan for the eurozone



Martin Wolf Author alerts

Europe has been unwilling to address the structural excess savings of creditor countries



Japan is no longer governed by consensus. This is true at least of its monetary policy. Haruhiko Kuroda, governor of the Bank of Japan, launched still greater “quantitative and qualitative monetary easing” last week, with the backing of only five of the nine members of the Monetary Policy Committee.

The BoJ plans to purchase Japanese government bonds at an annual rate of ¥80tn (\$705bn), or 16 per cent of gross domestic product. The balance sheet of the central bank is set to jump towards 80 per cent of GDP (see chart). This would make the BoJ’s balance sheet relatively far bigger than those of the US Federal Reserve, European Central Bank and the Bank of England (see chart). In addition, the BoJ plans to lengthen the maturity of its asset purchases to between seven and 10 years.

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The government pension investment fund has also announced that it will reduce its holdings of domestic bonds from 60 per cent of its portfolio to 35 per cent, while increasing its equity holdings (domestic and foreign) from 24 to 50 per cent. As a result, it will increase its holdings of Japanese equities by \$90bn and of non-Japanese equities by \$110bn. Indirectly, the BoJ is financing this by buying JGBs owned by the GPIF.

To justify its decision, the BoJ stated: “On the price front, somewhat weak developments in demand following the consumption tax hike [in April] and a substantial decline in crude oil prices have been exerting downward pressure.” As a result, it argues, there is a risk that “conversion of deflationary mindset, which has so far been progressing steadily, might be delayed”.

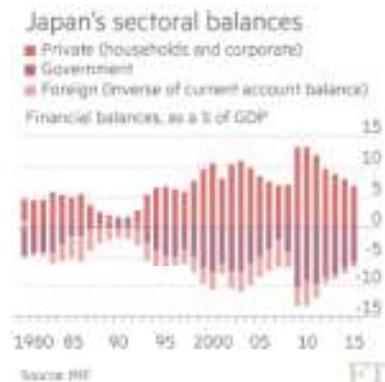
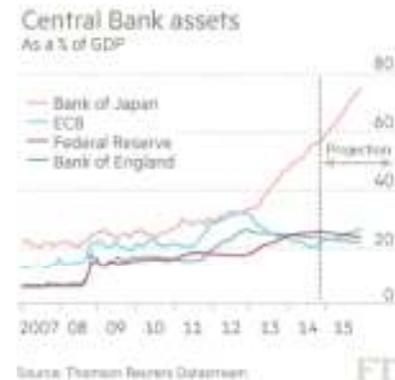
So will this reinforced attempt to end Japan's entrenched deflation work? To answer, one needs to distinguish the direct effects from the signalling.

The purchases of equities by the GPIF might be significant. But it is hard to believe replacing JGBs with money in private portfolios would make much difference. Central-bank money can also be thought of as non-interest-bearing, irredeemable government debt. But 10-year JGBs yield less than 0.5 per cent. So the difference between the two forms of government "debt" is tiny, particularly since the BoJ intends to reverse its monetary expansion at some point.

This makes the signalling the main channel. The decision is intended to underline the seriousness of the BoJ. But the split in the MPC must undermine the effectiveness of the signal it seeks to give and so weaken its impact.

The BoJ is combating the consequences of a bad policy error that it, alas, supported. The decision to raise the consumption tax this year was mistaken: it was mistimed, since it was introduced before the desired shift in inflationary expectations to an annual rate of 2 per cent had been entrenched; it was a tax on private consumption, of which Japan has too little, instead of on private savings, of which it has too much; and it did not address the structural cause of the latter, which is the chronic financial surplus of the corporate sector (the excess of its gross earnings over investment).

Since Japan's bubble economy collapsed in the early 1990s, the private sector has run a huge financial surplus, which has been the counterpart of the government's deficit and the net export of capital (see chart). Today, nearly all that surplus is generated within the corporate sector. The government will be able to eliminate its own deficit, while avoiding a return to economic depression, if and only if spending rises elsewhere relative to incomes. A jump in net exports would be one possibility. A rise in investment would be another. A shift of income from corporations to households, and a rise in consumption by the latter, would be a third.



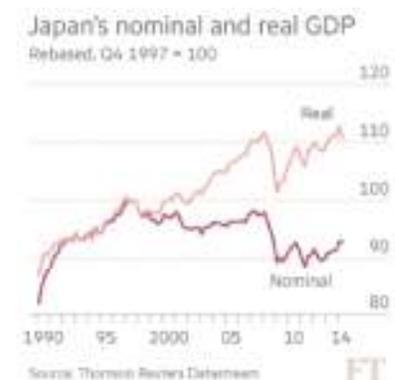
Could the BoJ's monetary policy deliver such outcomes? Only up to a point. Negative real interest rates might permanently raise wasteful corporate investment. Negative real interest rates should also depreciate the exchange rate and so raise the current account surplus. Last week's BoJ announcement weakened the yen by 4 per cent against the dollar between October 30 and November 4. Yet none of these shifts would directly tackle the structural problem in the corporate sector. Monetary policy would be no more than a palliative. Tax reform is needed – but the reform should include increased taxation of retained earnings rather than the government's proposed reduction.

An alternative monetary policy does exist: direct financing of fiscal deficits by the central bank (also known as "helicopter money"). This would not eliminate the economic imbalances but would finance their consequences in the most direct way. Given Japan's public debt overhang, however, such direct monetary financing of the government risks triggering an uncontrollable shift in expectations towards high inflation.

So what lessons should others, particularly the European Central Bank, learn from Japan's predicament? The answer is: do not start from there.

The Japanese are where they are for three reasons. First, the Bank of Japan pursued too tight a monetary policy, especially in the early 1990s, to punish the sins of the bubble economy. Second, the government added too rapid a tightening of fiscal policy in 1997. Finally, the Japanese never dealt with structural excess savings in the corporate sector. These mistakes entrenched the disinflationary pressure that the BoJ now seeks to end with its desperate expedients.

All this has strong echoes today in the eurozone. Not least, the dominant attitudes are needlessly punitive. The eurozone has also been unwilling to address the structural excess savings of creditor countries. Yet what the eurozone should remember is that, regardless of economic outcomes, Japan will remain a functioning country with an utterly loyal citizenry. The eurozone does not possess such powerful advantages. It cannot even risk falling into anything close to Japanese deflation. But it is.



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