More than six years have passed since the global financial crisis. The bold and timely policy responses, often involving international coordination, helped contain the impact of the crisis and the stability of the financial system now seems broadly restored. Nonetheless, the growth of the world economy has been sluggish. The Great Recession may be over, but the prospect for a return to robust longer-term growth remains uncertain.

Given the unprecedented scale of the global financial crisis, no one would have ever dreamed of a quick and strong recovery in advanced economies in its aftermath. The bold and sustained policy responses by governments and central banks helped prevent the Great Recession from turning into a Great Depression. Despite these policy measures, however, economies have remained weak in countries where the financial crisis was most severe. The drastic changes in the regulatory environment for the financial industry, including tightened credit standards, affected financial intermediation. Fiscal deficits, while supporting the economy in the short term, adversely impacted longer-term consumer and business confidence as well. The prolonged weaknesses of the economy and the uncertain prospects for the future have prompted a new debate on the possibility of secular stagnation or prolonged deflation in advanced economies, often citing Japan as an example.

This note focuses on the recent economic developments in Japan and considers potential pitfalls that policymakers in advanced economies may face in the post-crisis environment.

**Signs of a Turnaround**

It is unfortunate that Japan has come to symbolize economic stagnation and deflation, particularly when its present economy is showing emerging signs of recovery and growth. Japan embarked on bold monetary, fiscal and growth policies in early 2013, the so-called “Abenomics,” named after Prime Minister Shinzo Abe. The main goal was to ensure an exit from deflation and revitalize Japan’s economy. A year and a half has passed since its launch, and Abenomics initiatives seem to have succeeded in gradually reversing deflationary expectations and creating optimism that the economy is finally on course to regain solid growth and dynamism.

Images and headlines linger in our mind while changing realities are hard to detect and slow to be accepted. There is therefore little wonder why Japan has come to be regarded as a lesson in what not to emulate in the post-crisis policy debates. First of all, Japan’s economic stagnation, after its own banking crisis in the 1990s, persisted for many years. The period of prolonged lackluster economic performance was labelled as the “lost decade.” The incipient recovery from its own financial banking crisis in mid-2000s was interrupted by the global financial crisis in 2008, which plunged the economy again into a recession, prolonging the “lost decade” further. Secondly, the long-term demographic trends of an aging population and declining labor force also provided a stark background to the country’s image of stagnation and decline. Thirdly, the unemployment rate in Japan—5.5 percent at its peak—was not as high as it has been in the United States or in Europe, but
this likely reflected the willingness of workers to accept reduced wages rather than lose their jobs, an important feature which nonetheless reinforced deflationary expectations. Fourthly, while fiscal policies helped sustain domestic demand, the demographic trend has posed difficulties in restraining fiscal outlays for pensions and other social services. The resultant fiscal deficit became higher than most industrialized countries. In addition, the earthquake and tsunami of March 2011, which caused the loss of more 15,000 lives in the Tohoku region, inflicted real and psychological damage to the nation’s economy and consumer and business sentiments. The image of low growth and deflation thus lingered on until very recently.

The perception of Japan as an economy suffering from long-term stagnation is finally changing, a year and a half after embarking on proactive anti-deflationary policies. The Nikkei index rose by about 50 percent from the beginning of 2013 to the end of July 2014. The signs of reversal in consumer and business sentiments in Japan have become pronounced in recent months, despite the hike in the consumption tax rate since April 2014. Deflationary expectations are being replaced gradually by stable inflationary expectations. The rise in consumer sentiments has been helped by the gains in nominal wages, particularly for non-regular payments, which in turn were prompted by the emerging shortage of labor. The increase of nominal wages in the services industry has been markedly high, supporting the structural changes in the economy. Business sentiment too has improved significantly, and in March 2014 the Tankan diffusion index, published quarterly by the Bank of Japan, recorded its highest positive level since the early 1990s (+12), partly reflecting accelerated consumption in anticipation of the planned hike in consumption tax. It had been expected to flatten out in June (+1) due to the tax hike, but came in at a much higher positive level (+7) than generally predicted, reflecting the view in the market that the effect of the consumption tax will be absorbed over time without significantly affecting the general upturn of the economy.

The reversal of consumer and business sentiments is also helping the rebound of the real economy. In light of higher corporate earnings and rising business confidence, the government has been engaged in a kind of “reverse incomes policy,” a moral persuasion to increase wages of the employees by spreading the benefit to increase wages, a significant challenge for business leaders who have become prone to deflationary mindset. The unemployment rate was brought down to 3.7 percent in June 2014, and the ratio of job offers to job seekers has gone up to 1.10, the highest since June 1992. While consumption is being affected by temporary factors, such as the consumption tax hike and the unseasonable weather, the improvement of labor market conditions is expected to exert favorable effects to consumption over time. Private sector fixed investment in real terms has been increasing steadily since the first quarter of 2013, indicating the disappearance of over-capacity, the tightening of labor markets and the greater willingness of Japanese manufacturers to invest in domestic production facilities for strategically important products and research. Net exports have remained weak, mirroring the shift of production bases by Japanese manufacturers over the years stimulated by the prolonged period of a highly appreciated Japanese currency, combined with possible erosion of their competitiveness in certain sectors. But overall developments so far have clearly been positive and encouraging, culminating in 2.3 percent GDP growth for the fiscal year which ended in March 2014.

The most important development in Japan’s recovery has occurred in price movements. Up until early 2013, the core consumer price index either remained flat or recorded small declines, continuing its long-standing deflationary trend. In March 2013, for instance, it was minus 0.4 percent. Beginning in the middle of 2013, it became consistently positive. In July 2014, the Bank of Japan predicted that it will be around 1.3 percent in March 2015, 1.9 percent in March 2016, and 2.1 percent in March 2017, in line with the price stability target of 2 percent in the consumer price index set out jointly by the central bank and the government in January 2013. Reversing deflationary expectations
and anchoring inflationary expectations have been the major challenges for Japan. It now seems that the nation is finally overcoming this conundrum.¹

The image of a stagnant Japan may have concealed one important aspect of the country that was not dormant throughout the many years of low growth. During that time, a number of structural and regulatory reform initiatives were implemented as a major domestic policy drive to diversify the channels of financial intermediation and strengthen the role of financial markets. At the same time, many of these initiatives have been pursued in response to the internationally coordinated efforts to strengthen the global financial system in accordance with the globally agreed standards and codes laid out by international organizations—in particular the Basel Committee of Banking Supervision (BCBS) and the International Organizations of Securities Commissions (IOSCO), and subsequently by the G-20 Leaders Meetings since 2008. These reform efforts encompassed a complete overhaul of the regulatory structure, with the creation of an integrated financial regulator, the Financial Services Agency, to cover banking, insurance and securities markets. The overall reform included full implementation of the Basel Accords for internationally active banks, the overhaul of accounting and auditing standards, the strengthening of the resolution regimes for banks and other financial institutions, and the general reforms of bankruptcy regimes. The role of self-regulatory organizations (SROs) in the securities markets has also been strengthened in line with the IOSCO principles. Thanks to this overhaul of the financial regulatory system, Japanese financial institutions weathered the global financial crisis relatively well. Japanese banks have continued their role of domestic financial intermediation without any disruption and also played a role as a financial anchor in the tumultuous post-crisis years.

The critical change that these reforms in the past decade have brought about is a drastic transformation of Japanese capital markets. Significant-ly, they included measures to enhance corporate disclosure, to strengthen accounting and auditing standards aimed at international convergence, and to improve corporate governance. As a result, the cross shareholdings by large corporations, a prominent feature of Japan’s stock markets until the 1990s, have been reduced drastically, from almost 50 percent in the early 1990s to about 16 percent in 2014, or from about 30 percent to 11 percent in the same period, if holdings by insurance companies are excluded. The shares held by banks declined from 15.7 percent in March 1988 to just 3.8 percent in March 2013.² This trend was prompted not only by the regulatory initiatives to limit shareholdings by banks in a drive to upgrade the quality of their capital, but also by the introduction of fair-value accounting for financial instruments and the successive implementation of the Basel Accords. The steady integration of the Japanese capital markets into the global financial markets also reinforced and accelerated such trends, gradually transforming the governance and management styles of Japanese corporations. Currently, approximately half of the share transactions of listed companies on Japan’s stock exchanges are conducted by international investors. A significant percentage of the shares of all listed companies in Japan—30.8 percent at the end of March 2014—are owned by investors based abroad. Such developments, along with the presence of international financial firms and active direct investments abroad by Japanese corporations, are gradually changing the landscape of Japan’s economic system.

Recent policy initiatives are focused on strengthening corporate governance, a welcome development in accelerating further reform. The commitment made until the end of August 2014 by 160 major institutional investors, including the government’s pension investment fund (GPIF), to uphold the newly promulgated stewardship code to enhance the quality of their engagement with public corporations is also expected to play a key role in this regard.

It is still too early to proclaim that the recent macroeconomic and structural policies will put Japan on a long-term sustainable path to growth. Japan, the third largest economy in the world, is enjoying

¹ See text

² See text
enviable conditions—high per capita income, a large pool of private savings and highly developed and vibrant financial markets. However, in order to take advantage of this position, Japan is facing many challenges, including the issues posed by the demographic outlook. Sustained efforts for reform will be essential. Structural and regulatory reforms are the most important, but these reforms alone would not produce innovation and growth. The crucial additional ingredient needed is dynamism in the corporate sector to encourage innovation and productivity growth, underpinned by the encouragement of appropriate risk-taking and entrepreneurship. It is only through vibrant dynamism that a better allocation of capital and human resources can be achieved, bringing about productivity growth and structural changes in the overall economy. Corporate dynamism to take advantage of these reforms and translate them into productivity growth can only flourish in a non-deflationary environment. Deflation not only encourages postponing consumption and investment and benefits those who do not take risks. Deflation also stifles a forward-looking mindset, discourages competition and reinforces the status quo. The prospects of declining nominal prices and wages after financial crises are more prevalent than are generally believed in a post-crisis environment and can be the stickiest impediments to reform. While structural policies are ultimately important, the policy sequencing is crucial, and the success of structural and regulatory reform will depend crucially on how firmly inflationary expectations is anchored in the difficult post-crisis economic and political environment.

The Threat from Similarity with the “Lost Decade”

While many problems that have plagued Japan are caused by factors unique to the country, the possibility of prolonged stagnation after a financial crisis is more universal than has been generally thought. The high leverage of consumers and corporations during boom years has to be adjusted to the grim post-crisis reality of slower growth, persistently high unemployment and more stringent credit standards applied by banks. Such an adjustment, particularly by households, takes much longer than predicted by economic models, which probably fail to capture behavioral changes in consumers and businesses that occur as a result of traumatic experiences. These experiences may even affect sentiment for a generation. The erstwhile optimism is replaced by pessimism and the “animal spirits” of entrepreneurs become subdued, with the result that business investment embodying innovation or reallocating resources is depressed, adding to the slowdown in productivity growth and lowering growth potential.

The anti-deflationary policies pursued by Japan after its own crisis in the 1990s have been applied vigorously by other countries following the global financial crisis. The very low interest rate policy, quantitative easing, and other unconventional policies, piloted by the Bank of Japan but considered anomalous and heretical when implemented, have almost become a standard textbook approach. Central banks pursued expansionary monetary policies perhaps more boldly and confidently than was initially the case in Japan. These policies have contributed to stabilizing financial systems and containing the adverse impact of economic downturn. The bold monetary policies pursued by the United States and Europe seem to have so far contained the possibility of deflationary expectations becoming entrenched. The fiscal stimulus has also helped to prevent their economies from falling into a downward spiral. Despite these timely and bold efforts, however, growth has continued to be viewed as subpar and prospects remain uncertain. The similarity of the current situation with Japan’s earlier lost decade is now posing the threat of prolonged stagnation. It is therefore worth reviewing some of the difficulties in preventing deflation in the post-crisis policy environment.

Potential Pitfalls

There are several types of pitfalls which may pose particular difficulties for policymakers in preventing long-term stagflation or deflation after a
financial crisis. They are broadly related to three aspects: the analysis of the causes of deflation, distributional implications, and ideological divisions about the role of governments and central banks.

In analyzing the causes of deflation, it is not easy to distinguish between normal price stability and the dangerous signs of deflation. Price stability is traditionally measured in terms of the consumer price index (CPI) excluding fresh food. Japan’s annual average change in the CPI was minus 0.3 percent over the 15 years since 1998. In a post-crisis environment, aggregate demand is weak due to excess capacity, the lack of strong investment and also the slow growth or reduction of wages and bonuses. In an open economy, increasing competition from imports from lower labor-cost countries also exerts downward pressure on the general price level. Under these circumstances, a price stability of zero percent can easily be considered normal, if not desirable. In addition, on a more technical level, the CPI is known to have an upward bias, partly because of the innovation and technological changes which affect relative prices and resultant consumption behavior. Namely, the CPI is calculated on the basis of a presumed fixed basket of consumer goods, ignoring the effects of relative price changes on consumption of substitutable goods, particularly those involving technology-intensive consumer goods such as personal computers and mobile phones, where downward price changes are significant. Zero percent CPI movement likely overestimates price stability, and effectively means that deflation is creeping into the economy. The CPI may also underestimate the general price trend faced by businesses, particularly in manufacturing where product innovations are actively taking place and international competition is intense. Therefore, the recognition of these deflationary pressures tends to be delayed. In the case of Japan, policymakers, particularly the central bank, had been aiming at a price stability increase of above zero percent, but had seemed hesitant to set an inflation target of significantly above zero, presumably mindful of possible damage to their credibility and independence if such a target were not met. The absence of such a target may have further reinforced deflationary expectations. The mild price inflation target of around 2 percent, which is the normal price stability target for most of the advanced economies, was not set by the government and by the central bank until early 2013.

Secondly, there is a potential distributional aspect to formulating anti-deflationary policies. Those segments of the population that rely on fixed nominal income, including pensioners and those who have large bank deposits or fixed-income financial assets, benefit from deflationary tendencies at least in the short term. Conversely, the forward-looking segments of the population suffer, including the young workforce expecting advancement and an increase in nominal wages. Business managers and entrepreneurs with debt and households with mortgages and other debt also suffer, as persistently high interest rates in real terms increase their real debt burden. Since the elderly tend to be more politically active in voting than the young, it becomes difficult to install anti-deflationary policy as a major political agenda. Only political leaders with strong support from their legislature and with great communication skills can promote anti-deflationary policy forcefully.

The third and possibly the most difficult aspect is the ideological division that may emerge on the role of anti-deflationary policies when deflationary tendencies persist for a longer period of time. Proactive policies may gain strong public support as an immediate response to the crisis. But if they are used for a few years and prove slow in producing a robust turnaround in the economy, which would normally be the case in a post-crisis environment, then there will likely emerge frustration from all corners of ideological camps, leading to a division as to how long such supportive policies should be sustained or how forcefully they should be continued. Both fiscal and monetary policies conceptually have long-term trade-offs, requiring careful balancing.

As for fiscal policies, they can support the economy directly in the short term, and their active use
strengthens future growth potential, particularly through well-targeted upgrading of infrastructure. The low interest rate environment provides favorable conditions for the success of such a fiscal policy. Fiscal support to provide robust social safety net also plays an important role in facilitating structural changes and mitigating post-crisis difficulties. Nevertheless, fiscal stimulus could easily turn out to be ineffective or inefficient unless fiscal expenditures or tax policies are carefully designed to uplift growth potential and to avoid creating a false sense of stability. The ostensible economic growth largely dependent on public investment would likely end up creating “white elephants,” which in turn reinforce political pressures to prolong such expenditures. On this score, Japan has not been entirely successful, particularly in depressed regions; revitalizing regional economies has now become a major policy agenda for the government. Public investment should be designed to “crowd in” private investment and help create a business-friendly environment in order to ensure total positive returns to the public in terms of increased social benefits and tax revenues over the long pe-riod of time. Otherwise, it would certainly widen fiscal deficits to an abnormal level, exacerbating anxieties not only about future tax burdens but also jeopardizing the long-term fiscal viability and eventually the stability of the economic system.

As for the monetary policy, zero interest rate and quantitative easing monetary policies help support private investment and prevent deflationary expectations from becoming entrenched. Easy monetary policies also support the restoration of asset prices, which in turn help consumption and investment. However, such policies take time to produce the desired effects on the real economy, particularly when business and consumer sentiments are dampened in the process of deleveraging after the crisis and in the presence of excess capacities and inventories. Financial intermediation will also likely be affected by the balance-sheet problems of banks, consumers and businesses with high-leveraging. Moreover, the ongoing regulatory reforms and tightened credit standards will affect the normal transmission channel for monetary policies. Such a situation can easily give rise to debates about the desirability of easy monetary policies particularly when the rise in certain asset prices is detected or some signs of price inflation, however meager, appear. Under such circumstances, a strong temptation to backtrack on the policies may develop before deflationary expectations are fully reversed. An ideological division among policymakers could also emerge, with some parties being worried about creating another asset price bubble or potential inflation in the future, and others concerned about a premature change of policies before anti-deflationary expectations are fully anchored. Some policymakers might also be troubled by the perception of central bank independence being compromised because of the large-scale bond purchasing plans that quantitative easing policies would entail.

In a post-crisis deflation-prone environment, there seems to be no easy way for policymakers to ap-ply the pre-crisis textbook approaches comfortably and mechanically. On the contrary, the textbooks will probably have to be rewritten in light of the agonizing post-crisis experiences. Regardless of ideological views about central banking, nobody would deny that for central banks, controlling inflation is less difficult than fighting against deflation. The tools are now being explored to reverse deflation while containing future inflation and ensure financial stability, such as calibrated forward guidance, macroprudential and other regulatory measures. The increasingly important tool is the way the policymakers communicate with the mar-ket and the public in order to clarify the policy goals of avoiding deflation and anchoring inflationary expectations. Ideological divisions among policy-makers are inevitable and healthy in a democratic policymaking environment. But the policymakers, once in charge, need to ensure the effectiveness of communication by providing consistent messages with clarity and commitment, particularly when the task is to reverse expectations. This aspect may be particularly important in the eurozone, where policymaking additionally involves an assessment of diverse economic situations in the vast economic area. The most important goal for policymakers is to bring the real economy to a
robust growth path by anchoring expectations, paying attention to the economic realities on the ground rather than pursuing their own academic prestige or vindication of their ideological beliefs.

Investment for the Future

In a post-crisis environment, macroeconomic policies play the most important role in supporting the economy and employment. Over a longer run, however, it is the structural policies and the private sector responses that matters in ensuring longer-term growth. It is the private sector that creates jobs, growth and wealth; governments and central banks cannot produce them by themselves. Only private sector consumption and investment can support stable and sustainable economic growth. What matters over the long run is the way scarce resources are allocated. The allocation of risk-taking capital in the form of investment is particularly important, as it is through investment that human resources are reallocated to more productive sectors from less efficient sectors. The quality of investment is the key to increasing productivity through innovation, and enhancing the true value of wealth. The role of capital markets is therefore essential in this regard, not only in supplementing bank financing but also in producing the signals needed to transform the economy in a rapidly changing global and technological environment.

The key role of capital markets matters not only in developed countries but also in emerging economies. It is private sector cross-border capital flows, combined with the dissemination of human knowledge and upgrading of human skills, which ultimately play the most important role in ensuring the sustainable convergence of poorer countries with higher income countries. While capital flows are not necessarily a one-way movement, the prospect for active investment flows from high-income countries, embodying new technologies and management skills, will become brighter only where capital markets are underpinned by fair and transparent rules and institutions. This would be particularly true when corporations in high-income countries are hesitant to take calculated risks in a deflationary environment.

To reiterate, expectations matter more than past numbers in investment decisions. Policymakers are therefore required to make sure that deflationary expectations will not become entrenched so that stable inflationary expectations to encourage risk-taking investment will be anchored. They should not be content with the observed signs of stability in prices, which may not necessarily capture the true degree of deflationary expectations. The real problem of mild but persistent deflation in the aftermath of a financial crisis lies in suppressing the forward-looking mindset, particularly in high income countries, as people become defensive and inward-looking. In anticipation of lower prices in the future, they postpone consumption and investment. It rewards those who stick to the wealth accumulated in the past and take no risks. It discourages entrepreneurship, stifles innovation and deprives the young of opportunities to explore their potential through trial and error, which is the true source of innovation. A forward-looking mindset and a willingness to take measured risks only function in a stable non-deflation environment. The efforts to put our post-crisis struggles behind us are not over yet, and we are at a critical juncture in shaping our future economic well-being.
References


Haldane, Andrew. 2014. “Halfway up the stairs.” Central Banking Journal, August 5. Available at http://www.bis.org/review/r140807a.htm


Endnotes

1. See Kuroda (2014).


3. See Eichengreen (2014) and Haldane (2014) for interesting observations on the evolving role of central banks.