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Inflation: A Japanese Perspective

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Many years ago, the influential economist, Paul Krugman, published a paper where he identified the emergence of a "liquidity trap" in Japan, a phenomenon that, post the Keynesian interpretation of the Great Depression, many economists' thoughts were confined to the past.

The experience of Japan over the last twenty years or so not only exploded that myth but proved to be a warning to the West that Krugman identified in his paper. A long period of disinflation and outright deflation followed around much of the developed world sending interest rates to zero (and even below zero in Europe) as inflation collapsed and policy makers attempted to stimulate a recovery in demand. These attempts were hampered by the two crises of 2008 and Covid 19 leaving the world lamenting a lost decade of growth and possibly inspiring the rise of populism and its near relative, Trumpism.

All of a sudden, the aftermath of Covid, war in Ukraine, protectionism and limitations on freedom of movement and the transformation of Sino-US cooperation into Sino-US confrontation has led to labour shortages, logistics failures and supply constraints in key basic resources, generating an upsurge in inflation to the headline making rates of 9% across the OECD, 8% plus in the US, and our own central bank forecasting inflation later this year at 10%. Fears of deflation and a "liquidity-trap" have evaporated.

In effect, the supply-side of the economy has failed to meet a recovery in demand following the apparent "victory" over Covid.

These developments, of course, merit a policy response but what should that response be?

In the West, policymakers have turned away from the asset purchase programmes and low interest rates regime of the previous cycle. It is quite clear that Western "emergency financial assistance" has now ended; the easing of QE is quickly transforming into the tightening of QT and policy interest rates are headed higher. Bond yields have risen depressing fixed income markets and, naturally, equities are volatile as they process a higher cost of capital. There will be further ramifications in private equity, property and doubtless, "crypto" as well, in due course.

So, the Western response is to tighten policy – to suppress demand into the supply available thus slowing the rate of expansion and relieving burgeoning price increases.

The approach to this same problem in Japan, the harbinger of the world's earlier deflation, could not be more different. In a speech at the "Kisaragi-kai" meeting in Tokyo this week Governor Kuroda Haruhiko laid out his thinking and the contrast with the West is as dramatic as it is thought-provoking.

As elsewhere, Japanese inflation has risen, the most recent print was around 2.5%, high by Japanese standards but low by current Western standards. The Governor gives two reasons for this. Firstly, expectations of zero inflation are more embedded in Japan than elsewhere and secondly, whilst energy and consumer goods prices have risen, services prices have not.

In a departure from orthodox Western thinking, he goes on to say, "The key to changing this situation is higher wages." The idea is to heighten Japanese sensitivity to inflation by raising the cost of labour and thereby the returns to labour.

The mechanism to achieve this is to maintain, in absolute contrast to the Western response, “aggressive monetary easing” so that “actual inflation is reflected in wage increases.” Moreover, the high level of “forced savings” imposed on Japanese consumers during the Covid lockdowns has made them less attentive to and more tolerant of price increases in staple consumer goods. The bank wants to end this psychology.

He concludes by saying that “Japan is still under recovery from the pandemic and has been under pressure due to rising commodity prices. In this situation monetary tightening is not at all a suitable measure. The top priority is to continue with aggressive monetary easing centred on yield curve control.”

In other words, whilst we in the West will have to deal with higher managed interest rates and higher bond yields (US 10-year Treasuries already yield 3%), the Bank of Japan will maintain a zero rate and underwrite the market for Japanese bonds such that yields on such bonds will not breach an upper limit of 0.25%. Indeed, that is exactly where 10-year Japanese bonds trade today.

This might seem terribly arcane, and it probably is. However, it is rare that you get to see a “controlled real time experiment” in applied economics. Japan is doing exactly the opposite of what we are doing in the West.

The Governor is, at bottom, making the case that Japan is different. Yet, all economies are dealing with higher energy prices, resource scarcity and tight labour markets. Despite the retreat from globalisation, the world economy remains deeply inter-linked.

The Governor’s final claim is that “unlike other central banks, the Bank of Japan has not faced the trade-off between economic stability and price stability…and it is certainly possible for the Bank to continue stimulating demand from the financial side.”

Yet, Japan has the highest debt ratio in the developed world at 250% of GDP largely funded by the Bank itself which is itself widely considered a risk to stability and indeed, to the soundness of the Japanese Yen.

In this case, both sides can’t be right.

Warren Buffett once quipped that you don’t know who is wearing swimming trunks until the tide goes out. Well, either Governor Kuroda is and Messrs Bailey, Powell and Lagarde are not or vice versa. Either way, we will find out soon enough but then, perhaps, we shouldn’t look.