Another lesson from Japan

Stephen Roach | Yale University | 28 June 2017

Yet another in a long string of negative inflation surprises is at hand. In the United States, the so-called core CPI (consumer price index) – which excludes food and energy – has headed down just when it was supposed to be going up. Over the three months ending in May, the core CPI was basically unchanged, holding at just 1.7% above its year-earlier level. For a US economy that is widely presumed to be nearing the hallowed ground of full employment, this comes as a rude awakening – particularly for the Federal Reserve, which has pulled out all the stops to get inflation back to its 2% target.

Halfway around the world, a similar story continues to play out in Japan. But, for the deflation-prone Japanese economy, it's a much tougher story.

Through April, Japan's core CPI was basically flat relative to its year-earlier level, with a similar outcome evident in May for the Tokyo metropolitan area. For the Bank of Japan (BoJ), which committed an unprecedented arsenal of unconventional policy weapons to arrest a 19-year stretch of 16.5% deflation lasting from 1994 to 2013, this is more than just a rude awakening. It is an embarrassment bordering on defeat.

This story is global in scope. Yes, there are a few notable outliers – namely, the United Kingdom, where currency pressures and one-off holiday distortions are temporarily boosting core inflation to 2.4%, and Malaysia, where the removal of fuel subsidies has boosted headline inflation, yet left the core stable at around 2.5%. But they are exceptions in an otherwise inflationless world.

The International Monetary Fund's latest forecasts bear this out. Notwithstanding a modest firming of global economic growth, inflation in the advanced economies is expected to average slightly less than 2% in 2017-2018.

The first chapter of this tale was written many years ago, in Japan. From asset bubbles and excess leverage to currency suppression and productivity impairment, Japan's experience – with lost decades now stretching to a quarter-century – is testament to all that can go wrong in large and wealthy economies.

But no lesson is more profound than that of a series of policy blunders made by the BoJ. Not only did reckless monetary accommodation set the stage for Japan's demise, the country's central bank compounded the problem by taking policy rates to the zero bound (and even lower), embracing quantitative easing, and manipulating long-term interest rates in the hopes of reviving the economy. This has created an unhealthy dependency from which there is no easy exit.

Though Japan's experience since the early 1990s provides many lessons, the rest of the world has failed miserably at heeding them. Volumes have been written, countless symposiums have been held, and famous promises have been made by the likes of former US Fed chairman Ben Bernanke never to repeat Japan's mistakes. Yet time and again, other major central banks – especially the Fed and the European Central Bank – have been quick to follow, with equally dire consequences.

The inflation surprise of 2017 offers three key insights.

First, the relationship between inflation and economic slack – the so-called Phillips curve – has broken down. Courtesy of what the University of Geneva's Richard Baldwin calls the "second unbundling" of globalisation, the world is awash in the excess supply of increasingly fragmented global supply chains. Outsourcing via these supply chains dramatically expands the elasticity of the global supply curve, fundamentally altering the concept of slack in labor and product markets, as well as the pressure such slack might put on inflation.

Second, today's globalisation is inherently asymmetric. For a variety of reasons – hangovers from balance-sheet recessions in Japan and the US, fear-driven precautionary saving in China, and anemic consumption in productivity-constrained Europe – the demand side of most major economies remains severely impaired. Juxtaposed against a backdrop of ever-expanding supply, the resulting imbalance is inherently deflationary.

Third, central banks are all but powerless to cope with the moving target of what can be called a non-stationary liquidity trap. First observed by John Maynard Keynes during the Great Depression of the 1930s, the liquidity trap describes a situation in which policy interest rates, having reached the zero bound, are unable to stimulate chronically deficient aggregate demand.

Sound familiar? The novel twist today is the ever-expanding global supply curve. That makes today's central banks even more impotent than they were in the 1930s.

This is not an incurable disease. In a world of hyper-globalisation – barring a protectionist relapse led by the America Firsters – treatment needs to be focused on the demand side of the equation. The most important lesson from the 1930s, as well as from the modern-day Japanese experience, is that monetary policy provides no answer for a chronic deficiency of aggregate demand. Addressing it is a task primarily for fiscal authorities. The idea that central banks should consider making a new promise to raise their inflation targets is hardly credible.

In the meantime, Fed Chair Janet Yellen is right (finally) to push the Fed to normalise policy, putting an end to a failed experiment that has long outlived its usefulness. The danger all along has been that open-ended unconventional monetary easing would fail to achieve traction in the real economy, and would inject excess liquidity into US and global financial markets that could lead to asset bubbles, reckless risk taking, and the next crisis. Moreover,

because unconventional easing was a strategy designed for an emergency that no longer exists, it leaves the Fed with no ammunition to fight the inevitable next downturn and crisis.

We ignore history at great peril. The latest disappointment for inflation-targeting central banks is really not a surprise after all. The same is true of the related drop in long-term interest rates. There is much to be gained by studying carefully the lessons of Japan.

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