



# Growth requires higher productivity

## Japan emerges from deflationary mindset

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**F**irst the good news. The Bank of Japan's policy of quantitative and qualitative easing (the qualitative element targeting certain assets to drive up prices and reduce yields) has increased asset prices as part of an improvement in the BoJ's transmission mechanism, although this rise is yet to become excessive.

The risk of hyperinflation is even more remote than that of asset bubbles. There is no large-scale build-up of leverage in the private sector, and worrying about the risk of unsustainable bubbles in the economy is premature.

But there are risks attached to prolonged QQE, and – when exit finally approaches – the market will anticipate central bank action and interest rates could jump abruptly. This could trigger volatility on fixed income markets, disruption in the financial system and a premature economic downturn.

The BoJ announced in January that it would apply a negative interest rate to some excess bank reserves held at the bank. But central banking works effectively only in tandem with efficient money markets and a sound banking system. Negative interest rates could undermine this. The policy has no precedent in Japan's monetary history. It is unclear whether it will bring the desired equilibrium.

Premature central bank normalisation may undermine positive dynamics in the economy, but procrastination could eventually produce much higher inflation than desired. Both risks increase in proportion to the size of the fiscal imbalance and accumulation of public debt. Central bankers have cause to emphasise the importance of fiscal consolidation when engaging in ultra-easy monetary policy.

### QQE and its critics

Critics argue that monetary policy alone cannot raise trend growth and that it only buys time before structural policy takes effect. They say that Japan's slow economic growth-cum-deflation can largely be attributed to a declining and aging population. In addition, deflation in Japan has been persistent and mild, and not caused problems on a par with the deflationary spiral of the 1930s.

Other critics maintain that QQE has swollen financial asset prices, distorted resource allocation and paved the way for the bursting of asset bubbles. They believe that additional liquidity cannot easily be drawn down, and that there is a risk of hyperinflation.

These risks have global implications. QQE in Japan and quantitative easing in the

US have fuelled credit bubbles in emerging market economies.

I have some sympathy with such analysis, but disagree with the main arguments surrounding the monetary policy-economic growth nexus – or 'non-nexus' to be more precise.

The risk-sensitive critique is correct in that monetary policy influences financial asset prices. QQE has put upward pressure on equity and bond prices in yen, while putting the yen under downward pressure on foreign exchange markets.

These changes in financial asset prices have, in turn, influenced allocations and prices in a wider spectrum of assets such as commodities, property, goods and services. In other words, the change in liquidity in

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the system is shifting the old deflationary equilibrium into a new general equilibrium characterised by mild inflation.

### Deflationary equilibrium

Before Prime Minister Shinzo Abe launched the package of structural reforms known as 'Abenomics' in 2012, a general equilibrium had been reached under a relatively tight monetary policy.

This policy allowed deflation to persist, real interest rates to stay high and the yen to stay strong on exchange markets. A deflationary mindset was firmly established. Investments in cash, bank deposits and Japanese government bonds were encouraged as deflation enhanced their purchasing power. Equity investment, goods investment and borrowing were penalised.

From the individual's viewpoint, it made sense to minimise risk-taking and sit on cash. From a macroeconomic perspective, the lower the risk-taking, the lower the prospects for economic growth. A resurgence of economic growth would require technological innovation and resource reallocation from



Abenomics: Searching for a new equilibrium

'zombie' companies and sectors to more productive ones. By restraining risk-taking, tight monetary policy limited trend growth before QQE was launched.

Many domestic observers believe that a declining population is the main cause of slow growth, resulting in deflation. Population growth was 1% per annum in the 1960s, when the economy grew by more than 10% per year, and rose to a little over 1% in the early 1970s before gradually declining over time.

Before the bubble burst in the early 1990s, the economy grew at an annual rate of 4-5%. The recent annual growth decline to 0.5% mainly reflects lower productivity gains.

There are two other examples of 'growth arithmetic' which suggest the need for further evidence on the link between population and growth. First, while Germany's population barely increased in the 2000s and declined towards the end of the decade – even including migration – the economy grew without deflation.

Second, according to Bank of Japan Deputy Governor Hiroshi Nakaso in a speech in New York in February, average labour productivity in Japan was 30% lower than in the US or Germany in 2014. This suggests considerable room for productivity gains, and subsequent economic growth. The message for all concerned is clear: Japan's economic salvation must lie in creating an environment for higher productivity growth. ■

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