Potential for dislocation

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Record levels of government debt, as well as the weight of central bank financing, signal a potential shock in the making in Japan. The globalised nature of financial markets means that a shock on Japanese markets could prompt dislocations in other markets where government debt is accumulated – in other words, anywhere in the world.

In this report, John Plender concisely and accurately outlines the economic developments both before and after the launch in late 2012 of 'Abenomics'.

Prime Minister Shinzo Abe's programme aims to break Japan's deflationary equilibrium and guide the economy towards a 'new equilibrium' of sustainable growth with 2% inflation.

Abenomics consists of three 'arrows' – aggressive monetary policy, flexible fiscal policy, and growth-orientated structural policy. Its key elements are low real interest rates; a weaker yen; increased investment in equity, real estate, and other risk assets; higher prices for those risk assets; and greater risk-taking in the private sector, all to stimulate innovation and resource reallocation. Structural policy has aimed at increasing both wages and labour market participation.

The programme has had some success on all three fronts, but only to a limited extent. For example, consumer price inflation has moved into positive territory, but has yet to reach 2%.

Abenomics represents a response to the economic conditions prompted by the bursting of huge bubbles in Japanese real estate and equity markets in 1990. This ushered in a 'lost' two and a half decades during which economic growth was lacklustre at best and occasionally negative. Deflation emerged in the late 1990s amid a series of bankruptcies of large financial companies, and a deflationary equilibrium was established in the 2000s. In a prevailing climate of mild deflation, real interest rates were kept high, putting upward pressure on the yen exchange rate.

Savings in cash, bank deposits and government bonds were encouraged, while those in equity, real estate and other riskier investments were not. As a result, risk-asset prices were depressed, bond prices rose and private sector leverage was kept low. Government financing was so easy in nominal terms that by 2014 Japan had accumulated the world's highest levels of government debt.

During these decades, monetary and fiscal policy stimulus was applied to the economy on several occasions, but was unable to stimulate sufficiently strong and durable economic growth to end deflation. In the labour market, structural policy was used to increase wage flexibility, while unemployment was kept low. By remaining in a deflationary equilibrium, where risk-taking was penalised, Japan's economy gradually lost its vigour.

The Bank of Japan has continued to ease monetary conditions while the government has expanded its spending. Monetary policy operations have taken the form of huge purchases of Japanese government bonds at low or even negative interest rates. Plender notes that this appears to be paralysing politicians' sense of fiscal cost, as well as the market's function as a 'vigilante' of future risks.

Government debt monetisation by the Bank of Japan is fundamentally inconsistent with public confidence in the central bank maintaining the integrity of money. Plender, a member of the OMFIF Advisory Board, concludes by examining historical precedents of public debt monetisation in the UK, the US and Japan, noting that there are few successful soft landings.

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