Japan: inflation is not a sensible policy
by Andrew Smithers

Deflation provides a good example of economists’ bad habits. They assume that people behave in the same way even if they live in different countries and that their behaviour does not change over time. They are sometimes right. But deflation and inflation show how misleading this tendency to generalise can be. Today deflation is a danger for the eurozone, but not for Japan.

Deflation can cause problems, but not always. As I pointed out in my previous blog, since its market crashed in 1990, Japan’s gross domestic product grew more when prices fell than when they rose.

Deflation is usually bad for investment, but not for consumption. It is often claimed consumers postpone their spending when they expect prices to fall, ie, they increase their savings. The evidence is strongly against this.
As chart one shows, Japanese households have reduced their savings as inflation has fallen. Not only has the general direction of both been the same, but so, more often than not, have the blips. For example, savings and inflation both rose from 1987 to 1991 and again from 1996 to 1998.

The tendency for inflation and savings to move in the same direction is not just true of Japan. Chart two shows that in the US savings have risen as inflation has picked up and fallen back with its decline.

As Japan needs more consumption and less investment (a subject I plan to write about later), inflation is unlikely to help.

Another much misunderstood aspect of inflation is the claim that it helps reduce the national debt relative to GDP. This is only true under two conditions. First that debt is not much more than 100 per cent of GDP or second, that interest rates do not rise in line with inflation.

If real interest rates do not change, then nominal rates will rise by the same amount as inflation. If debt is below 100 per cent of GDP this will mean that interest payments rise
more slowly than nominal GDP and, if debt is above 100 per cent, they will rise more rapidly.

In practice, the break-even point is often above 100 per cent of GDP as nominal interest rates may rise more slowly than inflation. This happened in the UK after the end of the second world war, when exchange controls limited the free movement of capital. This is known as financial repression and seems unlikely to work in Japan today.

Japan has a gross national debt of 230 per cent of GDP and is therefore likely to find that within a year or so inflation will increase rather than reduce the fiscal deficit. A small rise in inflation to, say, 2 per cent would probably have little impact. But anything above that is likely to cause a panic in the bond market.

(In this context it is Japan’s gross debt that matters. The foreign exchange reserves are huge and bring the net debt down to about 150 per cent of GDP, but interest rates on these will not rise just because Japanese inflation rises.)