Rethinking Japan

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OCTOBER 20, 2015

The IMF held a small roundtable discussion on Japan yesterday, and in preparation for the event I thought it was a good idea to update my discussion of Japan – not so much about the question of whether Abenomics is working / will work (unclear, don't know) as about the current nature of the Japanese problem.

It's a bit self-centered, but I find it useful to approach this subject by asking how I would change what I said in my [1998 paper on the liquidity trap]. Hey, it was one of my best papers; and it has held up pretty well in many respects. But Japan and the world look different now, and trying to pin down that difference may help clarify matters.

It seems to me that there are two crucial differences between then and now. First, the immediate economic problem is no longer one of boosting a depressed economy, but instead one of weaning the economy off fiscal support. Second, the problem confronting monetary policy is harder than it seemed, because demand weakness looks like an essentially permanent condition.

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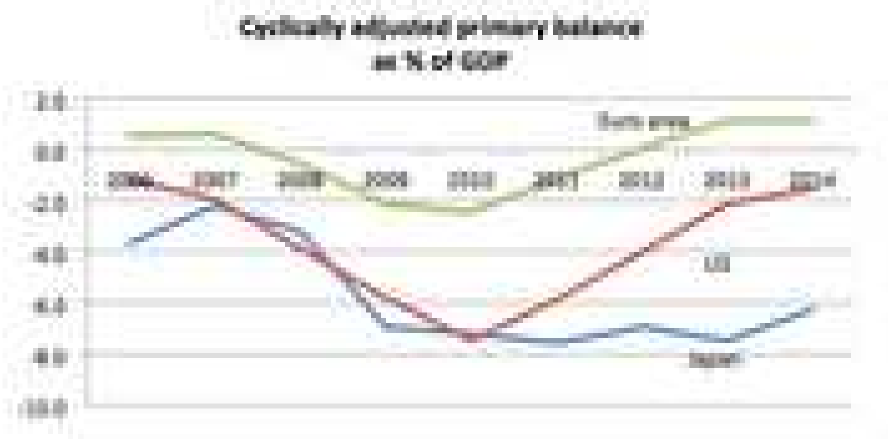
The weaning issue

Back in 1998 Japan was in the midst of its lost decade: while it hadn't suffered a severe slump, it had stagnated long enough that there was good reason to believe that it was operating far below potential output.

This is, however, no longer the case. Japan has grown slowly for the past quarter century, but a lot of that is demography. Output per working-age adult has grown faster than in the United States since around 2000, and at this point the 25-year growth rates look similar (and Japan has done better than Europe):

You can even make a pretty good case that Japan is closer to potential output than we are. So if Japan isn't deeply depressed at this point, why is low inflation/deflation a problem?

The answer, I would suggest, is largely fiscal. Japan's relatively healthy output and employment levels depend on continuing fiscal support. Japan is still, after all these years, running large budget deficits, which in a slow-growth economy means an ever-rising debt/GDP ratio:



So far this hasn't caused any problems, and Japan has clearly been much better off than it would have been if it tried to balance its budget. But even those of us who believe that the risks of deficits have been wildly exaggerated would like to see the debt ratio stabilized and brought down at some point.

And here's the thing: under current conditions, with policy rates stuck at zero, Japan has no ability to offset the effects of fiscal retrenchment with monetary expansion.

The big reason to raise inflation, then, is to make it possible to cut real interest rates further than is possible at low or negative inflation, allowing monetary policy to take over from fiscal policy.

I'd also add a secondary consideration: the fact that real interest rates are in effect being kept too high by insufficient inflation at the zero lower bound also means that debt dynamics for any given budget deficit are worse than they should be. So raising inflation would both make it possible to do fiscal adjustment and reduce the size of the adjustment needed.

But what would it take to raise inflation?