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American Account: Japan opens the taps to crush curse of deflation

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Enough is enough. That isn't a bad shorthand description of Japanese prime minister Shinzo Abe's new economic policy. Enough of lost decades, enough of deflation, enough of an overvalued yen, enough of wage stagnation, enough of Bank of Japan "timidity". More printing of money, more driving down the yen, more pay for workers, more spending by government. Add in some fundamental long-term regulatory reforms, and even longer-term changes in the anti-risk, lifetime job culture, and you have the reason for the rebirth of optimism in Japan.

We don't know yet whether the prime minister will be proved right in telling Barack Obama at their White House meeting that "Japan is back" — Abe himself later admitted some uncertainty — but we do know that share prices have soared by about 40%; the yen has plunged by about 25%; housing starts jumped 8.7% in February; and the outlook in the car sector is improving. All because the new head of the Bank of Japan, Haruhiko Kuroda, has said he will just about double purchases of Japanese government bonds to $75bn a month and "take all the measures imaginable" to break deflationary expectations and get inflation up to 2%, from its current -0.6%. If he succeeds, he would end the drag on consumer spending created by the expectation that waiting to spend pays off in lower prices tomorrow, a deeply embedded view that keeps some $8.8 trillion in cash and bank deposits stashed away by Japanese households. By 2017, opine economists Klaus Baader and Kiyoko Katahira at Société Générale, "the deflationary psychology should at least have been eased, if not broken".

Economists at the Lindsey Group are not so sure. They point out that the Federal Reserve Board's monetary policy committee has done exactly what the Bank of Japan now plans to do, but inflation in America has not increased. "The Bank of Japan cannot engineer sufficient additional inflation in Japan merely by expanding the money supply or lengthening its balance sheet. If America can't do it, why should anyone expect Japan to be able to?" the consulting group asks.

But even the cautious Lindsey Group sees hope for an economic recovery. After the most recent of many visits to Japan, Larry Lindsey, former White House chief economist, concludes that "something really feels different this time. Abe is a political brand that ... stands for something other than bringing home pork to the local constituency. The ongoing confrontation with China over the Senkaku Islands ... provides a natural catalyst around which the Japanese can unite behind a man like Abe".

Which brings us to the American reaction. One would expect that Abe's plan to drive down the yen — the prime minister prefers to call it reflation to avoid censure by the G20 for triggering a "currency war" — would not sit well in Washington. After all, Obama has promised to do all he can to increase exports, which certainly won't be made easier when Japanese consumers find their depreciated yen buys fewer dollars, making American goods more expensive there. The now-booming US car makers can't be delighted at the prospect of competing with Japanese car companies that can lower their prices and increase their profits as American consumers find their dollars buy more yen-based cars. And Obama's trade union backers can't be expected to cheer the employment effects they perceive will follow an increase in Japanese imports.

To which the Japanese officials I have met privately respond that a growing Japan is in America's economic interests. Sure, the sinking yen gives Japanese manufacturers a bit of an edge. But it will be politically easier for an expanding Japan to open its markets to foreign goods and investment, to sell its voters on trade deals that involve some concessions by Japan, and to welcome foreign investment.

All of which is of more interest to economic policy types at the White House than it is to those concerned with foreign and security policy. Abe understands this, and emphasised on his visit that "the trust and the bond in our alliance is back". In their meetings with me, Abe's supporters spoke of Japan's willingness and ability to "support the US forward military presence". At their joint press conference the president cited "our concerns about the provocative actions that have been taken in North Korea", and declared that "the US-Japan alliance is the central foundation for our regional security and so much of what we do in the Pacific region".

Abe fell in line with that. The security environment in the Asia Pacific region is "becoming more and more difficult", he said; the US and Japan must co-operate "to secure an order in the region . . . and the freedom of the seas . . . Concerning the South China Sea and the Senkaku Islands . . . the very existence of the Japan-US alliance is a stabilising factor".

In short, American policy-makers support what my interlocutors call Abenomics despite its possible negative economic effects here (denied by the Japanese) because the success of the Japanese economy, and of Abe who is friendly to us, is important to American interests in the Pacific region.

The question is: will Abenomics work? Possibly, but not certainly. Building inflationary expectations among businesses (so they will raise wages) and consumers (so they will spend more) is a daunting task, which Kuroda expects will take two years and doubters say is simply beyond the reach of monetary policy. In addition to the possible failure of Abenomics, the prime minister runs several risks, of which he is well aware.

- Loose fiscal and monetary policy might unleash hyperinflation, driving up the cost of servicing Japan's huge debt.
- The falling yen might result in com- petitive devaluations by Japan's rivals.
- Government stimulus spending might have little enduring effect on economic growth — a lower multiplier is the way economists put it.

Abe's supporters say these risks are far less than the risks of doing nothing — not a bad way of making economic policy in a long-stalled economy.

Irwin Stelzer is a business adviser and director of economic policy studies at the Hudson Institute. stelzer@aol.com