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A Factorial Analysis of Deflation and its Implications

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Economic Research Center, Economics Department

The Japan Research Institute, Limited

http://www.jri.co.jp/

For more information on the content of this report, please contact
Hisashi Yamada, Naoko Ogata or Hideki Matsumura
（03-3288-4245・5120・4524）

Since 1999, when deflation set in, the Japanese economy has effectively been caught in a "liquidity trap" and it would be irrational to claim that deflation is chiefly due to the failure of monetary policy. Some take the view that deflation is due to the failure of the BOJ to implement "non-traditional" measures, but given that Japan is caught in a "liquidity trap", and that such measures are, literally, "non-traditional", their efficacy is uncertain. Accordingly, the proper approach would not be to set an "inflation target" and entrust the specific means for attaining it to the BOJ, but rather, to consider the ways in which individual nontraditional measures will act, in specific terms, and determine their merits and demerits before debating whether or not individual measures should be implemented.

By contrast, some observers believe that monetary policy would have been effective, but that the decline of the credit multiplier means that quantitative monetary easing has failed to produce an increase in the amount of money available. Some also maintain that the decline of the credit multiplier is due to a "credit crunch" triggered by the problem of non-performing loans. However, the deterioration of the financial position of borrowers and the increased level of business risk cannot be overlooked as factorsin the decline of the credit multiplier. In other words, it is not so much the behavior of the banks as a fall in the number of high-return investment opportunities in Japan and a rise in the level of business risk that are to blame, and it would be inappropriate to consider the money supply-side problem of a "credit crunch" triggered by the problem of non-performing loans as the root cause of deflation.

Given that one of the reasons for the decline in the amount of money available is a rise in the level of business risk, Japan should aim to build a financial system that is capable of providing an adequate supply of risk money. Japan should aim to rebuild its financial system under private-sector leadership and, therefore should not only seek to create an environment that helps financial institutions to transform their business models, but should consider this issue from the perspective of the financial system as a whole, including the fostering of venture capital and the junk bond markets.

The fall in the number of high-return investment opportunities and the rise in the level of business risk have diminished the expected growth rate, and the fall in the expected growth rate has led, in turn, to asset deflation, causing the economic slump to become long-term.

The resultant widening of the supply-demand gap accounts for approximately 60% of the deflation that took place between 2000 and 2002. In particular, against the background of the ongoing decline in land and share prices that began in the early 1990s, the interaction of asset deflation and economic deterioration depressed the level of consumer prices by approximately 2.5% (an annual average of approximately 0.2%).

Moreover, given that the negative impact of the decline in expectations of economic growth is exacerbated by asset deflation, the government should take steps to halt asset deflation, including the introduction of tax measures to make investment in shares and real estate more attractive and the implementation of urban redevelopment projects to increase the profitability of land.

The global restructuring of industry, including the economic emergence of China, has exerted deflationary pressure on the Japanese economy by two routes: (i) by exerting downward pressure on prices due to the global fall in the production cost of goods, and (ii) by causing a widening of the supply-demand gap against a background of reduced capital investment in Japan due to the fall in net external demand (exports - imports) and the transfer of production to overseas bases.

These were major factors at the time that Japan first slipped into deflation, in 1999, and (i) explains approximately 25% of the deflation that took place between 2000 and 2002. If the knock-on effects (on the price of services) of (i) and (ii) are included, it appears that the global restructuring of industry accounts for approximately one-third of the deflation over this period. If the "indirect effects", whereby the fall in prices arising in this way has led to a downturn of the economy by reducing business profits are included, the fall in prices due to the global restructuring of industry is all the greater.

Some criticize the explanation that the influx of cheap products from Asia is exerting a downward pressure on prices on the grounds that it confuses relative price change and general price fluctuation. However, as far as can be told from actual data, in Japan, change in "relative prices", i.e. change in the prices of goods, has a strong impact on change in the prices of services, and therefore exerts a considerable influence on change in "general prices". The reasons for this strong correlation between the prices of goods and services in Japan are (i) the unique interrelation of industries in Japan, (ii) the weakness of the bargaining power of the non-manufacturing sector and (iii) the approach to pricing and business strategy taken by Japanese companies, which tend to give greater priority to cutting costs than transforming the structure of their businesses.

Thus, the causes of deflation between 2000 and 2002 can be summarized as follows:

1. Approximately 60% is due to the widening of the supply-demand gap, and around two-thirds of this stems from the vicious circle of asset deflation and economic deterioration.
2. Approximately 25% is due to the global fall in the production cost of goods.
3. The remaining 15% or so is due to the knock-on effect of the fall in the production cost of goods on the price of services, and to factors such as innovations in distribution and technology.

Given that the global restructuring of industry, including the development of China and the other Asian economies, has played a major role in Japan's present bout of deflation, a gentle depreciation of the yen would be desirable in order to (i) help adjust the speed of the transfer of existing industrial sectors to China and other Asian countries, and (ii) support the profitability of export industries.

However, in the medium-to-long term, the economic development of China and the other Asian economies is a desirable trend, and also represents an expansion of "markets" for Japan. In this light, Japan should build new relationships with Asian economies based on a division of labor, by transforming the structure of its domestic industry. The growth of business with Asia will generate fresh demand, narrow the supply-demand gap, and help to relieve deflation.

In the medium-to-long term, therefore, the most desirable policy stance for Japan to adopt with regard to the development of the Chinese economy is one that harnesses the growth of that economy in such a way as to promote the growth of the Japanese economy, even if gentle deflationary pressure persists.

It should also be emphasized that the surest way to bring Japan out of deflation is to support the self-help efforts of private-sector business corporations, in directions such as enhancing the self-sufficiency of the services sector and transforming pricing strategies (i.e. discarding low-price strategies in favor of the pursuit of new businesses, brand-based strategies and bespoke products).

In policy terms, therefore, it is important that the government should not only strive to make steady progress in areas such as deregulation with a view to encouraging innovation and increased spending on research & development, but should also pursue measures to ensure fair competition such as providing rent guarantees with respect to innovative businesses such as business model patents, and anti-dumping regulations.