Overcoming Deflation and Moving Forward

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Five years have passed since the global financial crisis, but the risk of deflation is still present in the global economy. Japan's recent signs of economic recovery and improved market sentiments provide an excellent opportunity to reconsider the challenges of overcoming deflationary expectations. This article argues that overcoming entrenched deflationary expectations rests primarily on monetary policy and that its success will depend on credible fiscal policies to reduce public deficits. The overall long-term policy goal is to encourage entrepreneurship and foster innovation, which proves difficult under a deflationary environment. Such policies should be supported by a regulatory framework that can ensure fair and transparent functioning of capital markets, thereby enabling efficient pricing of risks in allocating scarce risk-taking capital.

Bold Monetary Policy

Monetary policy in major countries has played a predominant role in responding to the global financial crisis. In the wake of the failures of many large financial institutions, major central banks provided liquidity to the financial systems under unprecedented stress. They also assumed a decisive role in macroeconomic management, resorting to nontraditional policies both in terms of instruments used and in terms of the scale in which they implemented them.

The Bank of Japan (BoJ) had pursued a strategy, now being followed by other major central banks after the crisis, centered on very low interest rates and quantitative easing (QE). With an aim of dispelling prolonged deflationary expectations, the BoJ recently embarked on a significantly bolder monetary policy, as part of the three-pronged approach of "Abenomics", an economic policy strategy of the new government headed by Prime Minister Shinzo Abe. This three-pronged policy consists of bold monetary easing, flexible fiscal policy, and a growth strategy to promote private investment.

Markets have so far responded favorably to this new policy initiative. The Nikkei 225 stock market index rose by 38 percent in the first six months since Prime Minister Abe took office. The developments in currency markets have helped ease deflationary pressures caused earlier by larger scale monetary easing in the U.S. and Europe. The optimism in Japan's stock markets has also been helped by the buoyancy of U.S. stock markets, where investors have become more sanguine about the recovery of the U.S. economy. There are now more signs that the recovery in Japan is gaining momentum, gradually spreading the optimism that the prolonged period of deflation will be finally over in the near future.

Lingering Nervousness

In Japan, given the prolonged and entrenched deflationary expectations, it is not easy to completely reverse such expectations. Nervousness and skepticism still remain about "Abenomics" and these new policies in the mind of some critics. These feelings seem to have been heightened by the recent volatility in the stock and currency markets, which have been driven primarily by the concern that the program of large-scale bond purchases in the U.S. will be tapered off much earlier than had been expected. This nervousness has spread around the world, but it has been most pronounced in Japan, where it is thought that a rise in long-term interest rates would have an adverse impact on the health of the banks that have been the major holders of government bonds. With the level of outstanding government debt extremely high, there are also worries that the impact on the government's borrowing costs might further enlarge fiscal deficit. This concern seems to be amplified by the signs of a stronger recovery that may edge up long-term interest rates, adversely affecting a long-term recovery prematurely.

While uncertainties are inherent in markets, the nervousness in the Japanese markets may be exaggerated for several reasons. Compared with other countries, the level of long-term interest rates is still the lowest in Japan. At the same time, the stock and bond markets are in the process of digesting the policy changes and it will take some time for a new steady-state to emerge. No signs have yet emerged that would encourage inflationary expectations to rise. In fact, an interesting analysis by the IMF's *World Economic Outlook*[1] argues that over the past decade or so, inflation in advanced economies has become less responsive to changes in economic slack and that long-term inflation expectations have become more firmly anchored. This suggests that ongoing monetary policy accommodation is unlikely to have significant inflationary consequences as long as inflation expectations remain anchored. This analysis is particularly valid for Japan, where deflationary expectations are deeply entrenched. In addition, while the potential impact of the rise in long-term interest rates may have an adverse impact on the profitability of banks, it is believed that the effect would be limited. In fact, encouraging banks to increase lending in order to support investment by borrowers, and discouraging them from sitting on investments in government bonds, is an important part of the overall economic policy strategy.

Obviously, it is premature to prescribe an "exit" from the unconventional monetary policy in Japan. Deflationary expectations will have to be dispelled and replaced by expectations of "price stability", defined as an inflation rate of 2 percent. This process will certainly entail a rise in *nominal* long-term interest rates above 2 percent from the current level of slightly below 1 percent. The key to the success of a bold monetary policy lies in ensuring the stability of long-term *real* interest rates, and will depend crucially on the ability of the government to set its deficits on a sustainable path toward reduction. If the ability of the government to ensure the sustainability of debt were to be seen as fragile, the perceived risk of the premature increase in interest rates would be heightened, jeopardizing the favorable impact of the bold monetary policy to sustain and support real economic activity. The effectiveness of the bold monetary policy therefore cannot be separated from the credibility of fiscal policy in controlling deficits over the medium term. In this environment, the "exit" policy of the central banks will not be an easy road back to the normal conduct of monetary policy, but will involve pressing the government to proceed with fiscal consolidation.

Preventing Deflation

Following the global financial crisis, preventing deflation has become a main policy agenda in many countries. The bold monetary policies pursued by major central banks reflect the sense of urgency with which they aim to prevent deflation and a return to recession, having in mind the prolonged deflation which has persisted after the bubble burst in Japan. Five years after the crisis, however, the fight against deflation and recession is not yet over in many countries.

Deflation can be very dangerous. It threatens the stability of the economy and the society in the long-run. Deflation makes firms and households excessively risk-averse, due to the devaluation of assets held by households and firms. Inability to lower real interest rates toward zero hampers monetary policy. Households and firms who have outstanding debt suffer from the real increase in the debt burden. With the prospect of decreasing prices, household consumption is postponed and businesses become cautious in making investment decisions given the perceived high real interest rate. Business sentiment is also adversely affected by greater uncertainties about the future of the economy and the undervaluation of the market capitalization of firms in the stock market. Risk-taking activities, necessary for innovation, are generally suppressed and the economy starts shrinking, depriving the youth of job opportunities and on-the-job learning—an impact that could last a generation. Investments are likely to shift abroad due to high real exchange rates, further depriving job opportunities at home.

When deflation is mild, however, such danger may not be fully recognized by political leaders or by the public. The danger of prolonged mild deflation is likely to be underestimated and fighting deflation might not gain policy priority. In fact, there are some segments of society, such as pensioners, who may benefit from prolonged mild deflation. The public begins to accept a zero increase or mild decrease in the consumer price index as price stability, not recognizing the real dangers. Deflationary expectations become entrenched, leaving the long-term real interest rate at a high level and slowly depriving the economy of entrepreneurship and the risk-taking that is necessary to move the economy forward. Only when this deflationary process becomes a visible vicious cycle does its danger become recognizable.

Exploring Policy Options

Debates will continue on the effectiveness of various policy options in preventing and overcoming deflation. The assessment will not be easy as there have been varying degrees of clarity of policy intentions, and in the strength of their implementation. In the absence of clear positive results of policies, the public may become impatient in the process, triggering political changes and bringing about policy reversals which can exacerbate uncertainty. In many cases, various policies are mobilized simultaneously and the outcome is the product of all, influenced simultaneously by external developments.

Several points seem worth noting, especially in light of Japan's experiences so far. The role of fiscal policy in supporting the economy and the social safety net should not be underestimated. In the immediate aftermath of the financial crisis, private sector net savings spiked as households and firms cut investment, and households saved more, resulting in a huge increase in budget deficit. Tax revenues fell sharply while expenditures adjusted slowly, serving as an automatic stabilizer in the economy. Fiscal policies have also been used more proactively to fight deflation and reduce unemployment. Expenditures on the social safety net have helped alleviate the burden that falls on the socially vulnerable, including the young and the unemployed. Fiscal expenditures on infrastructure projects helped upgrade the quality of public services, which may have been needed regardless of the economic situation.

Overall, however, the effects of fiscal policy on reversing deflationary expectations seem to have been limited. The ballooning deficits have raised concerns about debt sustainability, and eventually eroded confidence in the ability of government to sustain the level of public services and social safety nets including public pensions and medical insurance. These greater uncertainties of the future dampen household consumption and depress business sentiment. In the eurozone, the situation is more complicated and room for fiscal policy is limited. The withdrawal of fiscal stimulus is being required in countries with financial difficulties in order to steadily restore fiscal sustainability. In addition, the use of fiscal policies is further constrained by the level of real interest rates, which may have external effects on the economy. In an open economy, the effects of fiscal policies might spill over abroad through the appreciation of exchange rates.

In summary, fiscal policies may have proven effective in the short run, particularly in supporting the economy and maintaining the social safety net, but not in overcoming deflationary expectations in the long-run.

Under these circumstances, monetary policies naturally assumed a predominant role in fighting deflation, as discussed above. There have been a series of debates on how much of the deflation is a monetary phenomenon. Certainly, there are non-monetary factors—such as demographic factors, technological changes and intensified international cooperation—that exert downward pressure on the general price level. Nevertheless, it has also been clearly recognized that monetary policy has a crucial role to play in reversing deflationary expectations.

The BoJ has been taking a bold approach. Since the spring of 2013, it has replaced the gradual and incremental approach with a bold one in pursuing the explicit inflation target of 2 percent. In April, it announced that the monetary base and the central bank's outstanding amount of Japanese government bonds and ETF holdings would be doubled in two years, with the average remaining maturity of the bank's bond purchases extended to more than twice as long.

The challenges facing central banks in fighting deflation are enormous. First, short-term interest rates are close to zero and do not effectively serve as operating targets. Even if there is room for cutting interest rates, the effect on the cost of new financing would not be as large when households and firms are cutting the existing debt by active deleveraging. The operating method therefore needs to depend on unconventional policies, including QE, with the monetary base serving as the operating target.

Second, monetary and fiscal policy become closely intertwined in a deflationary environment. In such an environment, household and corporate sectors tend to record surpluses while the government sector runs deficits. The QE approach can be taken by the central bank confidently only if it has a reasonable basis to judge that its independence is respected and that its actions are in no way interpreted as monetizing fiscal deficits. The credibility of a medium-term fiscal consolidation program is therefore a prerequisite to bold QE, as discussed above. In the case of the BoJ, its policy decision was made possible by a joint statement with the Japanese government, in which the government stated that it would steadily promote measures aimed at establishing a sustainable fiscal structure and at ensuring the credibility of fiscal management. The BoJ also made it clear that its purchases of government bonds would be carried out solely to achieve the price stability target and not in any way to finance the fiscal deficit.

Finally, central banks need to overcome ideological hurdles in pursuing unconventional policies. No central banker would want to be seen as compromising its independence, and many of them are naturally hesitant about embarking on non-orthodox policies, particularly on QE through aggressive purchases of government bonds. There are "hawks" that would be willing to criticize any departure from the orthodoxy within and outside their circle. These hawks can be politically strong in many countries, particularly where the memories of high inflation or excessive real estate bubbles are still fresh. In the case of eurozone countries, the orthodox philosophy seems to be combined with the fear that such policies may eventually lead to countries with strong fiscal discipline bailing out countries with less fiscal discipline. This heightens the challenges for the European Central Bank in carrying out bond purchasing policies, as necessary. Ultimately, many central banks will have to navigate through rough waters of skepticism and criticism.

Fostering Business Investment and Innovation

Overcoming deflation means bringing the economy back to a steady path of growth, based on private sector consumption and investment particularly on robust business investment, embracing entrepreneurship and fostering innovation. Business investment requires mobilizing scarce risk-taking capital of private sector investors. The role of capital markets is to mobilize such scarce capital and allocate it to innovative firms and projects. For capital markets to function effectively there should be sufficient risk-taking capital and a willingness to utilize it, with the depth and liquidity of the markets, supported by robust institutions and practices, allowing efficient and fair pricing of risks and returns.

Deflation erodes the core function of capital markets in several ways. In a deflationary environment, the totality of risk-taking capital becomes smaller as excessive risk aversion becomes a rational behavior. When prices are generally expected to decline, credit risk premiums become larger with the rise in the real interest rate and the probability of default becomes higher. Most importantly, the general lackluster stock market performance, a measure of general recognition of these risks in the economy, and the undervaluation of the capitalization of listed companies reduce the confidence of business leaders, who become excessively risk-averse and hesitant to take forward-looking decisions on investment.

Bold monetary policy through QE has therefore had a favorable impact on the ability of capital markets to play a significant role in creating an environment for reviving business investment. In this regard, setting a clear inflation target, typically 2 percent, is particularly helpful in reversing deflationary expectations and embracing adequate risk-taking in a market economy.

The faster recovery of the U.S. economy, both in terms of international comparison and in terms of historical experiences, is due in no small part to the monetary policy strategy of preventing deflationary expectations and ensuring vibrancy of its capital markets. Thanks to bold monetary policy, the deflationary impact was contained, with no significant decline in general price levels. The reforms to improve the function of capital markets have been pursued largely independently from the reforms made to strengthen capital requirements of financial institutions while preserving the depth and liquidity of capital markets. The existence of a broad range of risk-taking investors and entrepreneurs has also helped to keep the market working well. Had the financial intermediation been predominantly based on banks, it would have taken much longer for the U.S. economy to start its recovery.

The situation differs in other countries, particularly in Europe. Many banks have been struggling to raise capital to meet stricter capital requirements, limiting their ability to provide financing on risky investments. In the wake of the global financial crisis, hostility toward financial institutions has naturally grown stronger, due to the excessive risk-taking behaviors or inappropriate conduct prior to the crisis. Such hostility is especially strong in countries where large financial institutions were bailed out with public funds. The purpose of the financial regulation reforms initiated by G-20 countries is to prevent financial institutions from taking excessive risks that could jeopardize the stability of the system and to ensure their soundness. While it is important to reform the financial system to prevent future crises by preventing excessive risk-taking by individual financial institutions—particularly by systemically important financial institutions, it is also important to distinguish risk-taking by individual institutions with the risk-taking activities in capital markets within the economy as a whole.

The reforms to prevent excessive risk-taking by financial institutions should be accompanied by efforts to strengthen the role of capital markets to allow risk-taking capital to be allocated to investment, stimulating innovation and growth. The appetite of investors to take measured risk and endorse entrepreneurship is not unlimited in any circumstance, but it is particularly limited in the wake of financial crises. Strengthening investor protection and ensuring integrity and transparency in financial markets is the only way to preserve the depth and liquidity of capital markets, enable efficient pricing of risks and foster entrepreneurship.

For capital markets to function efficiently, a robust regulatory framework must be in place to ensure fairness, integrity, and transparency. Regulating capital markets is a complex exercise. It involves not only supervising financial institutions according to their changing risk profiles, but also monitoring their conduct and behavior to protect investors. It is important to work with many governmental and non-governmental institutions, including judiciary authorities, exchanges, clearing houses, self-regulatory organizations and other stakeholders. It requires the collaboration of a variety of stakeholders supported by the rule of law, good market practices and institutions to provide efficient market infrastructure within individual jurisdictions. In addition, given the rapid integration of financial markets, international harmonization and consistency in regulatory policies are indispensable. Embracing openness and avoiding nationalism are key to ensuring sufficient liquidity and depth of the markets. Otherwise, regulatory arbitrage would take place, making regulation less effective for all investors around the world.

Financial markets are changing rapidly, with technological innovation and international integration continuing to pose many new policy challenges. They include implementing internationally-agreed regulatory codes and standards, as well as addressing other emerging issues related to new trading technologies, increased complexity of financial products, and the reliability of financial benchmarks, among others. Addressing these issues requires international cooperation with strong political leadership. Going forward, G-20 leaders will continue to have a major stake in this process.

References

International Monetary Fund (2013), *World Economic Outlook*, Washington, D.C.

Endnotes

[1] See International Monetary Fund (2013), Chapter 3.