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Is the Japanese miracle coming to an end?

More than concerns over the fiscal deficit numbers per se, the challenges for Japan lie in the short-term international economic environment and more importantly, the chronic, long-term structural issues that Japan confronts

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NOVEMBER 02, 2022 / 08:58 AM IST

(Representative image: Reuters)

Highlights

- *The yen has depreciated sharply this year against the dollar*
- *As a result, imported inflation has gone up*
- *The Japanese government has gone in for fiscal stimulus to protect people against the rise in the cost of living*
- *Inflation would be kept in check through subsidies on household electricity bills and gasoline prices, enabling the BoJ to maintain its low interest rate policy*
- *The short-term problems could be the last straw for Japan's sclerotic economy*

With the yen depreciating by some 30 percent this year, from 116 ¥/$ in January to 150 ¥/$ on October 21, 2022, in spite of the Bank of Japan's (BoJ) reluctant interventions of some ¥6.35 trillion ($43 billion) in October alone, Japan faces challenging macroeconomic policy choices but, at the same time, not so dissimilar from the situation prevailing in many advanced and developing countries.

The reasons for such a large depreciation in the yen are not surprising: the sharp increases in interest rates by the US Federal Reserve (Fed), full convertibility of the yen which makes capital flight easy and most importantly, the low interest rate policy that the BoJ continues to maintain. While the Fed's benchmark rate is now 3.25%, the Bank of Japan's (BoJ) key short-term rate is at negative 0.1%. The yield on a 10-year Japanese government bond is at just 0.244% (less than a quarter of a percent) while that on a US government bond of the same duration is presently at more than 4%.

The immediate consequence of the falling yen is imported inflation. Total (headline) inflation hit a 40-year high of 3.4% while narrow (core) inflation rose to 2.4%, above the BoJ's target of 2%. While this rise in the inflation rate might seem that Japan has finally got what it has desperately sought for a long time – having struggled with low inflation and deflation for decades – it isn't. The present bout of inflation does not come from a pick-up in aggregate demand but rather from depreciation of the yen, which has pushed up the domestic price of imported fuel and commodities.

The **BoJ** has expressed concern that 'moves to increase wages will not strengthen' given the 'the behaviour and mindset … that prices and wages will not increase easily are deeply entrenched.' With imported inflation and no change in nominal wages, real wages are actually declining, driving down aggregate demand so that 'prices will deviate downward from the baseline scenario.' It is for this reason that the BoJ is steadfast on its low interest policy that may dampen demand even further and has instead chosen to let the yen slide with the hope that demand for higher wages will come from gradual tightening in labour markets.

This, however, seems unlikely. Earlier this year, **The Economist** reported that unemployment in Japan is at 5%, way above official records as many people have voluntarily stayed out of the labour market. Large-scale layoffs have also been reported across sectors ranging from electronics to construction and automobiles. Factory output fell 1.6% in September 2022 with a 12.4% decline in auto-related production.

Rising imported inflation and falling real wages resulted in widespread dissatisfaction with Prime Minister Fumio Kishida, reflected by a sharp drop in his approval ratings. In this context, how could Japan (and the BoJ) hope for a sustained revival in aggregate demand through real wage increases? The only remaining option was for the Japanese government to once again resort to aggressive expansionary fiscal policy. A fiscal package of about ¥29 trillion (approximately $200 billion or ₹17 lakh crore) was unveiled on October 28. Prime Minister Kishida categorically stated the objective of the package: 'overcoming rising prices and reviving the economy… to protect people's livelihoods and businesses.'

Inflation would be kept in check through subsidies on household electricity bills and gasoline prices, enabling the BoJ to maintain its low interest rate policy. At the same time, the fiscal package hoped to stimulate aggregate demand and induce wage increases. While the package was seen as a positive step, some commentators argued that the stimulus was insufficient and should have included cuts in the 10% consumption tax.

As usual, alarmists have raised concerns over Japan's public debt levels which are now in excess of 250% of GDP. However, as witnessed in this instance too, there has been no volatile disruption in Japan's financial markets on account of the stimulus package, contrary to the mayhem that was seen in the UK last month. This is because unlike the Bank of England, the BoJ accommodated the announcement of the government to keep yields stable through bond purchases. More than concerns over the fiscal deficit numbers *per se*, the challenges for Japan lie in the short-term international economic environment and more importantly, the chronic, long-term structural issues that Japan confronts.

Like many other countries, Japan must grapple with the Fed's decisions to hike US interest rates, and the rising energy and commodity prices on account of the Ukraine-Russia war. This will continue to exert pressure on the yen to depreciate and imported inflation too will continue in spite of the large fiscal subsidy package. Although GDP growth has improved, it still remains below 2019 pre-pandemic levels. The positive indicators in the short-term for Japan are growth in its exports which touched a record high of ¥8.8 trillion as well as an increase in service sector growth. Lifting of Covid restriction for tourists and the depreciated yen may result in a further uptick in this sector.

While Japan must endure short-term pressures and uncertainties until US inflation eases and the war in Ukraine ends, it is the long list of long-term factors, each adversely reinforcing the other, that are more worrisome: stagnation in GDP growth since the 1990s, deflationary pressures from the lack of aggregate demand, low levels of consumption spending, a secular decline in Japan's consumer confidence index, slow wage growth, declining levels of private sector investment spending, technological inertia, the rising levels of non-performing assets held by commercial banks and to top it all, Japan's demographic changes of a declining and ageing population.

A prolonged short-term recovery will only add to Japan's long-term woes.

Although Japan's problems must not be conflated with those of poverty, there is an ominous feeling that the Japanese miracle maybe reaching its end. If it weren't for its exports, the riposte would have been more definitive.

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