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Deflation Outlook Worse than Nineties

Tax on cash and JGB's could spur shift to consumption, boost economy

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- European monetary easing ineffective, zero growth in China
- Japanese deflation exacerbated by growing supply/demand gap
- Negative interest rate policy could trump deflation

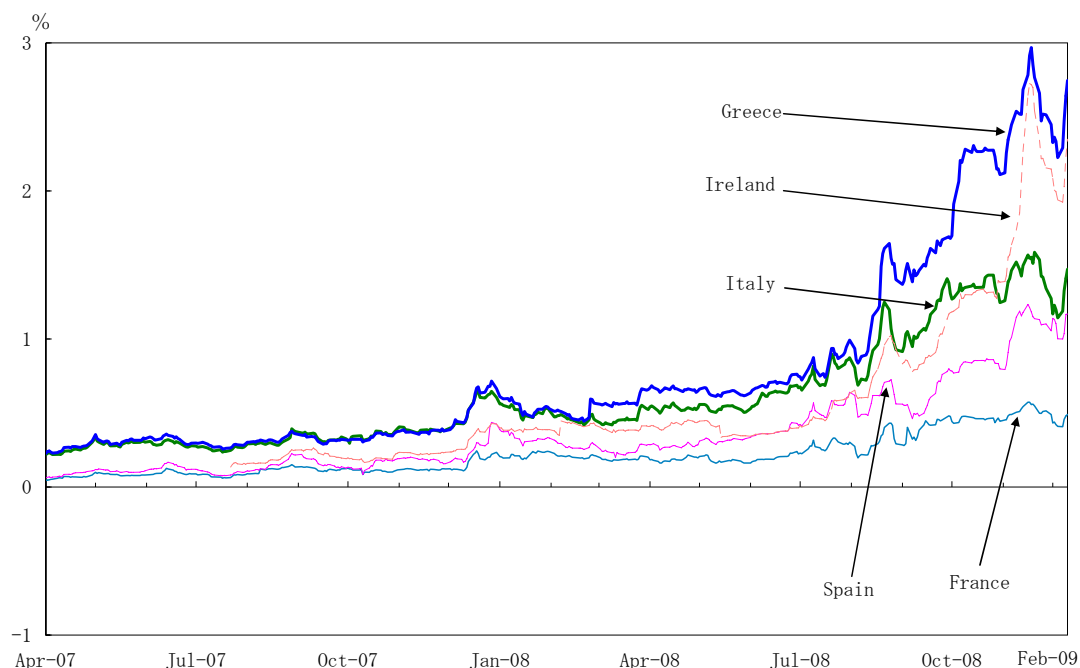
Despite policy responses by governments and central banks worldwide, the global financial crisis unleashed in the United States remains as dire and implacable as ever.

Just how has the crisis affected the world economy so far? Since trends in the U.S. are comparatively well known, I will focus mainly on analyzing the situation in Japan, Europe and China with a view to exploring how Japan might pull out of this severe economic slump.

Real estate prices in Europe and the United States show that prices turned down around 2006 in the U.S. and thereafter continued falling at an accelerating pace. In Europe as well, housing prices turned south somewhat later than in the U.S., or around 2007. The rate of increase in housing prices since 2000 was on a par with or faster than that of the United States. This alone serves to show that, rather than being solely the result of contagion from the U.S. financial crisis, the financial enervation affecting European financial institutions may be regarded as the manifestation of long-standing underlying problems which have been triggered by the financial crisis.

Government debt yield spreads have been widening among nations in the European region. The lowest yields are on German government bonds, over which Greek and Irish government bonds trade at a risk premium of 200 to 300 basis points, with Italian and Spanish government bonds trading at premiums in excess of 100 basis points. These premiums, moreover, are growing wider (see Figure 1). This situation indicates that the European Central Bank's monetary easing has not had an effect in these countries, and that supporting them by monetary easing is becoming difficult.

Figure 1. Risk Premium on the Debt of Selected European Countries (vs. German Government Bond)



Source: Bloomberg

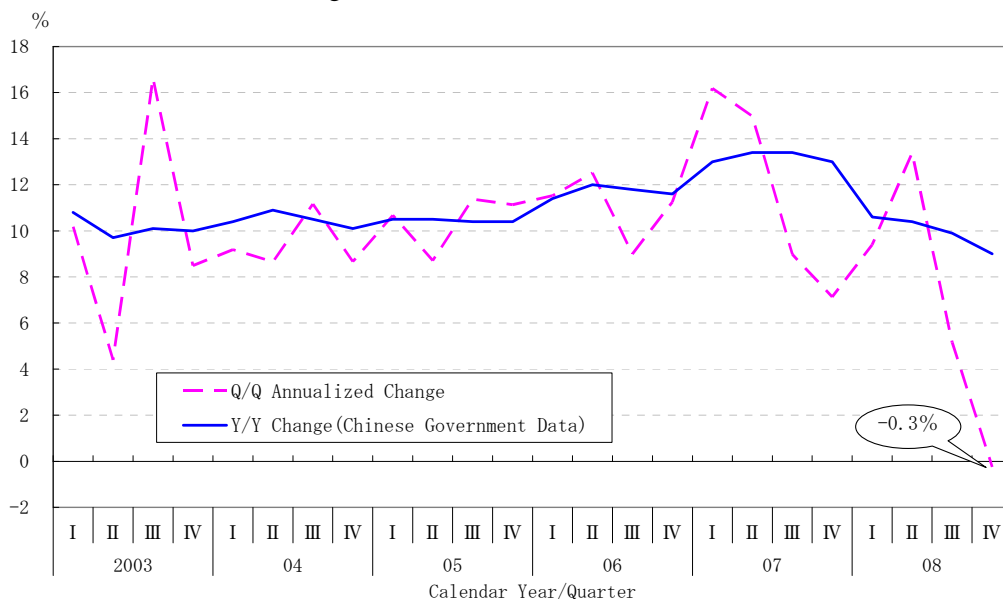
Eastern Europe, meanwhile, is being pulled into a negative spiral in the wake of the financial crisis owing to its interdependency with the West. In the countries of Eastern Europe, financial institutions based in Western Europe hold a very high market share, exceeding that of local financial institutions in many Eastern European countries. Behind the high share has been the aggressive lending by German and Australian financial institutions in line with the economic growth in Eastern Europe.

However, they are increasingly repatriating capital back to their home countries in the wake of the financial crisis, giving rise to lending squeeze in the Eastern European nations. Since Western European countries depend on Eastern Europe for exports, such a lending squeeze has not only impaired the growth of Eastern European countries but undermined the exports of Western European nations as well.

In China, meanwhile, restrictions on capital transactions remain strict, and as a result, the impact of the global financial crisis on China has been limited, at least in the financial sphere. In terms of its real economy, however, China remains heavily dependent upon external demand, and the negative impact has been substantial. Given a decline in demand of global proportions, it is likely that Chinese growth in real terms fell to zero beginning in the second half of 2008 (see Figure 2).

The growth rate of China's real gross domestic product (GDP), which the Chinese government publishes quarterly, is a year-over-year comparison, and so no direct assessment of the quarter-to-quarter (Q/Q) changes can be made from published figures. We have therefore estimated seasonally adjusted China's quarterly growth rates from the published data. According to our estimates, the Chinese economy posted comparatively strong Q/Q growth through the first half of

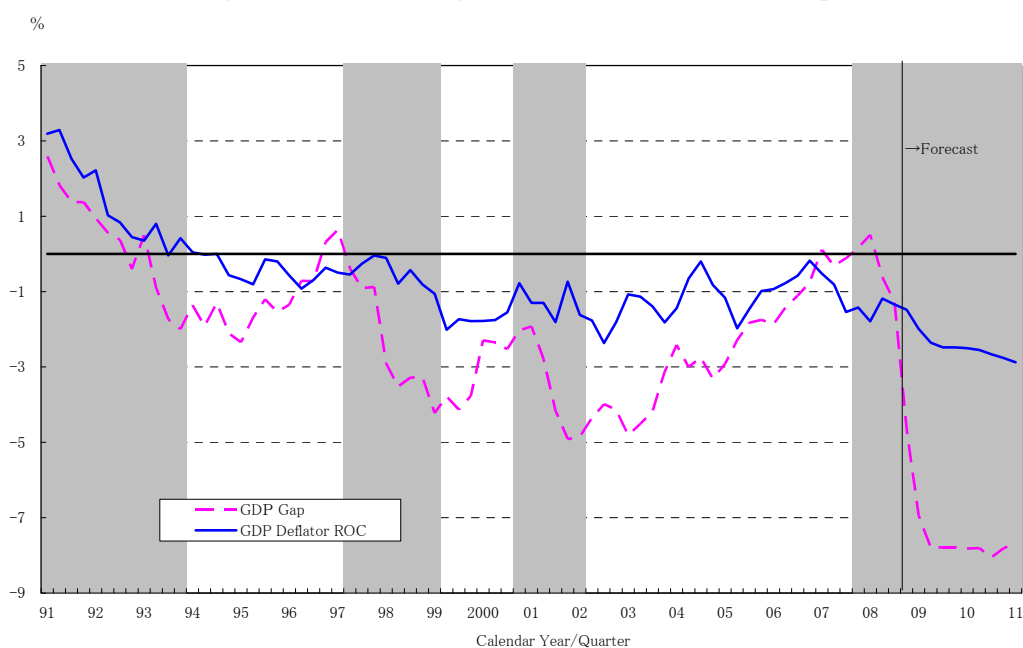
Figure 2. Real Chinese Economic Growth



2008, but the real growth rate for the July-September was 5.2%, falling below 6% for the first time in about five years, or since the April-June quarter of 2003. Chinese economic growth fell to about zero (down 0.3%) in the October-December quarter as its growth came to a screeching halt.

The European and Chinese economies have therefore gone into the tank right behind the United States, where the crisis originated. And this has delivered a stunning blow to the Japanese economy, which is now grinding to a standstill. Using our Phillips curve estimates together with the values projected under our short-term outlook for the Japanese economy, we have estimated the economy's supply/demand gap (the GDP gap) and the inflation measured by the GDP deflator (see Figure 3).

Figure 3. Rate of Change in GDP Deflator and GDP Gap



The GDP gap in the April-June quarter of 2009 was -7.8% by our estimates, showing not only a dramatic but unprecedented widening (i.e., excess supply). The largest GDP gap seen since the 1990's was -4.9% posted in the October-December quarter of 2001, so it may readily be seen just how severe the present drop in the capital utilization rate is. Assuming this estimated GDP gap is on the mark and forecasting the rate of change in the GDP deflator using our Phillips curve, we expect deflation to worsen to -2.9% by the January-March quarter of 2011. This shows the worst figure seen since the collapse of Japan's economic bubble and indicates that Japan teeters on the brink of a deflationary spiral.

In a deflationary economy, investors have a greater incentive, despite low yields, to hold cash (which involves no default risk) or to hold such assets as deposits and government bonds, which are backed by the credit of the government. When prices are falling, land and stock prices decline, but the value of cash does not. For this reason, nonresidential fixed investment and residential investment are sluggish while cash and deposits increase.

The Bank of Japan could step up quantitative easing and outright buying of corporate debt, thereby lending some support to the economy, but this will have limited effectiveness. And given its massive fiscal deficit, the government has little capacity left to shore up the economy. Devaluation of the Yen cannot be the option this time, although that could be done in 2003-2004.

Does all this mean there's no way out of this mess? What we may need to consider now are the pros and cons of negative interest rates.

To be sure, there is no guarantee that bank lending will expand just because the BOJ lends money to financial institutions and business firms at negative interest rates. The reason is the existence of huge amounts of safe assets, namely cash. And if banks are able to borrow from the BOJ at a negative 2% rate, they might very well just borrow money from the BOJ, sit on the cash and collect a 2% margin risk free.

Through astute use of taxation, however, it may be possible for the government to collect tax revenue while stimulating the economy. This could be done through a policy of making interest rates negative in real terms, and it may be worthwhile to consider this kind of "negative interest rate policy" going forward.

The concept of negative interest rates has been familiar since the initiative of the German economist Silvio Gesell for a stamp tax on paper money was introduced by Keynes in his *General Theory*. Gesell proposed taxing cash by providing many columns on paper money where revenue stamps were to be attached. If weekly stamps were not attached to the bills, they could no longer be used as currency.

Today there are ATM's and vending machines all over, and it would be very inconvenient to use bills as currency with stamps on them. In addition to cash, moreover, people can hold deposits guaranteed by the government or make extensive use of credit cards, debit cards or electronic money to make payments. For this reason, taxing cash only would have limited impact in stimulating expenditures. It could be effective, however, if the method of taxation were changed.

For example, one desirable option might be imposing a deadline by which money must be used or making it so the value of money falls if it is not used. This would be the same principle as that employed in electronic retail stores' points or airlines' mileage credits, which must be used before they expire, however much prices might decline.

The government might thus impose a tax on any increase in the real value of financial assets (such as cash, deposits and bonds, the value of which is guaranteed by the government) arising as a result of deflation. Thus the government collects the increase in the real value of financial assets by deflation as tax. The tax would be imposed on any yen-denominated financial asset guaranteed directly or indirectly by the Japanese government, including Japanese government bills and bonds (JGB's), local government bonds, savings and cash. In the case of cash, the government could change the color, print new bills and then impose a fee to exchange old bills for new.

If such measures were pursued, money would shift from taxable safe assets to equities, corporate bonds, durable consumer goods, real estate and the like, stimulating the economy. Banks would also likely reduce their taxable current account deposits with the BOJ and boost lending. Considerable political difficulties would no doubt be involved, but a tax of 2% could be expected to yield revenues in excess of 3 trillion yen. This is the amount received effectively in change even after a cash handout of 200,000 yen to each member of the public.

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