

2015-06-05

PRESS RELEASE

Deflation in Japan, Abenomics and lessons for the euro area

(Article in the June 2015 Economic Review)

Seven years on from the global financial crisis, the euro area economy has not yet fully recovered: growth has remained significantly below pre-crisis levels throughout the most recent period, with inflation staying low and punctually even turning negative. This combination of stalling economic activity and weak inflation/deflation has long described the state of the Japanese economy. With this in mind, this article discusses similarities between the euro area's current situation and the developments that have prevailed in Japan over the past two decades. It concludes with several lessons the euro area might draw from the Japanese experience and policy responses.

In the early 1990s, a major financial and property bubble burst in Japan and its economy suddenly faced the twin challenges of a balance sheet recession and a banking crisis. During this balance sheet recession the country's corporations chose to increase their savings and to pay down their debt rather than to spend or invest, which led the government to step in to support aggregated demand. At the time, the banking crisis was already in the making but its full force did not erupt until 1997, when the Asia crisis hit. This crisis, which caused the demise of a good number of key financial institutions, finally forced the country into recognising the problem of non-performing loans, which had been weighing on economic performances already for some time. The banking industry ended up being recapitalised by the government.

Given that deflation remained moderate – although persistent – and that Japan's economy never did get dragged into a deflationary spiral, it may be argued that the country evolved towards a new equilibrium between the early 1990s and the start of the 2000s. This new equilibrium involves nominal interest rates close to zero and negative inflation, but real growth close to potential. This is corroborated by an analysis of real growth per capita and per person of working age: the country's performances prove quite good since the 2000s when compared with those for the euro area and the United States. Therefore, the 'lost decade' epithet bandied about for Japan in the 1990s has to be put in perspective, and is inapt for the 2000s. Although the Japanese economy would seem to be growing at a level close to potential, the new-found equilibrium comes at a price. A deflationary regime such as Japan's indeed reduces the ability of the central bank to support economic activity in the event of negative shocks, and therefore increases the risk of secular stagnation. With that in mind, the economic programme implemented in April 2013 and known as Abenomics is attempting to put an end to the lengthy period of deflation that Japan has been through and to boost the country's economy while factoring in the long-term sustainability of its public debt.

There are three key lessons to learn from the Japanese experience of the past 25 years. The first is that it is better to prevent financial crises rather than to cure them after they materialise. This may sound evident in today's world, but the Great Recession suggests that policymakers had learned little from the events in Japan. A second important lesson is that it is crucial to maintain a firm anchoring of inflation expectations: once deflation becomes embedded into an economy's DNA, it is difficult to fight and extreme measures are then needed to get inflation expectations back on track. The third lesson is that a balance sheet recession requires prompt and coordinated action to achieve the maximum effect for any measures taken and to facilitate necessary adjustments. Joint macroeconomic policies should be put in place to bolster both supply and demand. Finally, it should be noted that Japan's experience has taught that the cost of deflation is a function of the specific features of an economy and, in particular, its nominal flexibility. To the extent that the latter seems lower in the euro area and since the loss of the exchange rate instrument demands that relative domestic prices be adjusted to correct loss of competitiveness, deflation costs threaten to be higher. The need to ward off any risk of deflation in the euro area would thus appear to be even larger.