The Asia-Pacific Journal | Japan Focus

Volume 14 | Issue 3 | Number 4 | Article ID 4850 | Feb 01, 2016

Rethinking Japan's Deflation Trap: On the Failure to Reach Kuroda Haruhiko's 2% Inflation Target

R Taggart Murphy

Fifteen years ago, Akio Mikuni and I were working on a book that we ended up calling Japan's Policy Trap. At the time, a chorus of prominent foreigners was berating Japan's policy elite for its refusal to take their advice on lifting Japan out of deflation. But we believed that Japan faced more than just a stubborn unwillingness by politicians and bureaucrats to do what needed to be done. That's why we labelled Japan's dilemma a trap; after all, if you can escape from it easily, then it really isn't a trap.

That is particularly true of deflation. Postwar Japan had first flirted with deflation in 1995, but by the time our book came out in 2002, prices had fallen for four straight years. While the consequences of deflation, unlike the fact of it, might be open to some debate – you could (and can) find arguments that in an aging society falling prices aren't always a bad thing – there isn't much difference of opinion that deflation makes it hard to pump the engines of growth. If you want to get nominal GDP growing (real GDP plus or minus inflation/deflation) – and that is really important if, like Japan, you are sitting on a large and growing pile of debt since rising nominal GDP is the only route out of your debt problem – prices pretty much have to start climbing, or at least quit falling. Otherwise, people will hoard cash, since whatever they need to buy will be cheaper tomorrow than it is today. Businesses will defer investments and look to cut costs rather than seek new markets. As salaries fall (a salary is also a price – the price of someone's labor) and employment opportunities dry up, people will seek to protect themselves from economic insecurity with more saving – in other words, with less spending – leading to yet more belt-tightening by business. The result? A vicious, self-reinforcing cycle.

Vicious it may be, but, fortunately, ending deflation is easy, or at least that was the line famous economists such as Paul Krugman and Adam Posen were preaching back then to Japan's policy establishment. You announce an inflation target and have the central bank flood the economy with money until you get there. Presto – problem solved!

So why wouldn't the Bank of Japan ("BOJ") take this obvious step? Many explanations on offer started with the BOJ's determination to solidify its standing as a genuinely independent central bank. The BOJ had long been seen as little more than an operating arm of the Ministry of Finance, but a law passed in 1998 had provided for its theoretical independence. Courting inflation by caving to political pressure to gun the money supply was the last thing a grown-up, newly independent central banker wanted to be caught doing.

But inflation was nowhere to be seen in the Japan of the late 1990s. Posen sputtered in anger at the BOJ's supposed quavering at inflation phantoms – ending deflation had to be the first priority of any central bank in the BOJ's position. In a 1998 book, Posen explicitly called for the BOJ to set a 3% inflation target[1]; Paul Krugman in a paper that same year suggested 4%, albeit hedging the recommendation with an admission that the suggestion was made more to "stimulate serious research" and to "overcome (s) the instinctive negative reaction of many policymakers" to the notion of managed inflation.[2] The only explanation that seemed to make sense for the failure of the BOJ to take this advice lay in these widespread notions that Japan's central bankers were some sort of monetary policy equivalent of backward-looking generals fighting the last war.

But while America's central bankers may be haunted by tribal memories of the complicity of Arthur Burns' Federal Reserve in the inflation of the 1970s (Burns, chairman of the Federal Reserve from 1970-78, has been plausibly accused of gunning the money supply in the run-up to the 1972 US presidential election in order to enhance Richard Nixon's re-election chances), no such charge can be leveled at the Japanese authorities. In 1974, inflation in Japan stood at 25%; in 1975 it had been cut to 3%, admittedly at the price of steep recession. Japan came bursting out of that recession within a year, while the rest of the developed world would stagger on through the 1970s burdened by both stagnation and inflation – "stagflation" they called it. The jaw-dropping success of Japan's policy response to the global 1973-74 recession was probably as important as the preceding 15 years of double-digit growth in leading to the growing "Japan as Number One" hubris among Japan's elites – the sense that began to take hold in the late 1970s that they really didn't have much to learn any more from the West.

Thus the notion that the BOJ was staffed by retrogrades blindly sending the central banking equivalent of cavalry on horses to take out nests of machine guns simply didn't stand up to any close examination of recent history. Nor did the image of a BOJ jealously guarding a supposedly new independence. It is true that the 1998 law purportedly establishing the BOJ's independence had just been passed and it is also probably true that many BOJ staffers had long chafed under the perception that the BOJ was more of an operating arm of the MOF than a genuinely independent central bank making its own disinterested determination of interest rates or bank reserve levels. (Mikuni and I compared the status of the BOJ in the Japanese system to that of the Federal Reserve Bank of New York in the American – the New York Fed is the most powerful of the Fed's various branches and does indeed carry out much of the operational side of policies determined in Washington, but it does not itself originate policy).

But it had never been necessary in Japan to "isolate" monetary policy from politics; the totality of monetary and financial policy including the chartering and oversight of the banking system and the supply, direction, and price of credit had been under the control of the Ministry of Finance since the 1927 financial crisis that had seen a string of bank failures and a bond market collapse. In the aftermath, the MOF had stepped in to consolidate the Japanese banking system, bring the banks directly under its supervision, and terminate a theretofore free-wheeling bond market as a significant source of Japanese corporate finance. MOF increased its control over the financial system yet further in 1940 when it put the economy on a war footing (the eminent Waseda University professor Noguchi Yukio has pinned the label "the 1940 system" on Japan's postwar economic arrangements since the measures taken by the MOF in 1940 were never removed, they were simply re-ordered in the immediate postwar years so that companies with a demonstrable capacity to earn dollars in export markets obtained the privileged access to credit that had theretofore been granted to munitions makers – often, e.g., Nissan, Hitachi, Nippon Steel[3] – the same companies that simply retooled production lines). The MOF deflected feeble attempts by the Occupation to assert control of finance and money – a job made easier by the misunderstandings among Occupation officials of the way the wartime Japanese economy actually worked. Staffed (at least in its early days) by unrepentant New

Dealers in thrall to Marxist notions of a supposed alliance of "capital" and militarists as the cause of war, the Occupation sought to break that alliance up rather than aim for the real drivers of Japan's war economy in its economic bureaucracy. (In fact, Japan's genuine capitalists had at best lukewarm enthusiasm for the war and were generally distrusted by the bureaucrats who ran the war economy.) The MOF tacitly supported what the Occupation was doing; thus unlike other powerful wartime bureaucracies such as the Imperial Army and the Naimusho ("Interior" Ministry) that the Occupation disbanded or broke up, the MOF emerged from the Occupation with its powers further enhanced – the Occupation had, conveniently for the MOF, weakened or eliminated rival power centers (in particular, the families who owned the great prewar zaibatsu conglomerates and were stripped of their holdings). Since the end of the Occupation in 1952, the MOF has had to make concessions from time to time to political developments, but it has never surrendered its control over the key financial levers of the Japanese economy.

Even the BOJ's purported new independence in the 21st century was, on closer examination, not quite what it appeared. BOJ governors were still drawn periodically from the MOF and the MOF still controlled the BOJ budget. Differences of opinion on what policy ought to be did of course emerge from time to time and those differences did sometimes coincide with the MOF/BOJ institutional divide. But the notion that the MOF might sit on the sidelines wringing its hands helplessly while the BOJ stood in its way is to misunderstand the way policy is determined in Japan. Or so we argued.

But didn't what happened a decade after Mikuni and I wrote our book suggest that there may have been some truth after all to this notion of a structural and conceptual MOF/BOJ split? Didn't the MOF in 2013 manage to get its own man into the governor's chair at the BOJ, and didn't he finally override internal opposition at the BOJ to what Krugman and Posen (and many others) had long advocated: announce an inflation target and start flooding the economy with money? Wouldn't the only mystery be why it took so long to do the obvious?

Yes, Kuroda Haruhiko was appointed to the governorship of the BOJ in March, 2013, and yes, he had risen from within the ranks of the MOF, going from Director General of the International Finance Bureau (the key position in foreign exchange rate policy) to Vice Minister for International Affairs to one of the MOF's supreme rewards for its most highly regarded veterans: presidency of the Asian Development Bank. And yes the BOJ did announce an inflation target shortly before Kuroda took over, and yes he did start to flood the economy with money with the aim of reaching that target. But Kuroda was not actually the MOF's choice for the job (more on this later), and as of this writing, inflation has not come anywhere close to the 2% target; in fact, prices have hardly budged.

How can this be? Didn't Milton Friedman, the guru of monetary economics, famously decree that inflation is always and everywhere a monetary phenomenon? That if you "print" a lot of money, prices are going to rise?

Mikuni and I contended that the nature of the Japanese financial system made it more difficult simply to conjure up a given level of inflation than would be the case in the West (although given what has happened since 2008 in the United States and Europe, we overestimated the ability of Western central banks to create inflation in today's world.) We also argued that the BOJ and MOF naturally understood this since the two bureaucracies not only supervised the financial system but were effectively its architects. We suggested that BOJ officials might be reluctant to announce an inflation target because they knew they had no way to guarantee that the target would be achieved. And, of course, this is what has happened – at least to date. The 2% inflation target is nowhere in sight.

To convey the problems the BOJ faces in sparking inflation, I'm going to have to make a slight detour to describe how banks create money in the modern world. On the dollar bill or 1000 yen note in your wallet, you can find the words "Federal Reserve Note" or "Nippon Ginko Ken," and the bill in question was indeed issued by the Federal Reserve or the Bank of Japan as the case may be. But most of the world's money does not come in the form of bills that can be carried around in a wallet and it is not "printed" by central banks. It is created mostly by private financial institutions.

Banks conjure into being most of the money in an economy through what is known as the fractional reserve system. This system has long generated a lot of hype, not to mention clouds of equations, but as John Kenneth Galbraith once remarked, "the process by which money is created is so simple that the mind is repelled." Let's say you put one hundred dollars on deposit in the bank. Maybe the bank keeps twenty of those dollars in its vaults (after all, you might need some of the money you had deposited to pay a bill or maybe you want to pull 20 dollars out of the ATM to buy lunch – the bank keeps some cash around against just those eventualities.) But it lends out the rest. Let's say it loans 80 dollars to a business that uses the 80 dollars to pay one of its workers. That worker puts the 80 dollars on deposit in her bank. Notice that while you still have 100 dollars in your bank, the worker now has 80 dollars in hers. That 80 dollars wasn't there before and now it is.

The process doesn't stop there. The worker's bank lends out 64 of those 80 dollars where it shows up as a deposit in yet a third bank. If each bank keeps twenty percent of what is put on deposit and lends out the rest, your initial deposit of $100 ends up "creating" $400 of new money. Central banks can kick-start this process (or short-circuit it if they want to reduce inflation) by putting new money on deposit with private banks (or pulling money out of the banks.)

But there was a subtle difference in the way this process worked in Japan and it has to do with matters of profitability, the distribution of risk, the ways in which bad loans are written off and absorbed, and, ultimately, with the institutional reason for being a bank in the first place.

Western[4] financial institutions are primarily driven by considerations of profit-making. They look for opportunities to capture a spread between what they have to pay for money and what they can earn by deploying it. They expect that a certain percentage of the loans they make or the bonds they float will go bad. That is why riskier borrowers have to pay more for money in the form of higher interest rates than do safe borrowers; the higher interest is how they compensate their lenders for the higher risks. But if riskier borrowers do in fact return the money they have borrowed, banks will have earned more than they would have with safer borrowers. This is why banks are constantly tempted into riskier business – because it is more profitable (always assuming the banks get their money back.) To counteract this temptation towards risky lending, regulators will restrict the amount of business banks do with dodgy borrowers and insist that banks maintain a sufficient cushion of money in the vaults to cover risks from the business they do end up doing.

In an ideal world, prudent bankers would of their own volition limit exposure to riskier borrowers. But we have learned over the last century that governments will step in to bail out a failing financial institution if it is large enough that its collapse threatens general prosperity. After all, modern societies need institutions that can be relied on to deploy savings and process payments every bit as much as they need institutions that can be relied on to provide electricity; no government can stay in power if these fundamental needs are not met. Thus the story of Western finance over the last generation is a tale of a mad scramble by leading financial institutions to become so big that they cannot be allowed to fail – and, not coincidentally, thereby accumulating so much money and power that they can generally arrange for favorable regulation. Secure in the knowledge that government must bail it out when things go wrong, a sufficiently large bank or brokerage has every incentive to take as many risks as it can get away with. This heads-we-win-tails-the-taxpayer-loses setup has been exacerbated at least in the United States by the repeal in 1999 of the Depression-era Glass-Steagall Act, which had kept deposit-taking institutions out of the riskiest parts of finance, and by the shift in the ownership structure on Wall Street away from partnerships where the principals risked their own money. American bankers in the largest financial institutions today gamble with other people's money, and somebody else – shareholders or taxpayers – picks up the tab if the bets go wrong.

But nobody in this system pretends that risk doesn't exist. The entire mental galaxy of Western finance revolves around notions of risk. Every Wall Street hire, every finance major or MBA candidate with his or her eyes on a career in banking is marinated in the capital assets pricing model, risk/return tradeoff, modern portfolio theory, the Black Scholes Model, the efficient markets hypothesis. Risk – defining it, distributing it, planning for it, off-loading it – lies at the center of these sometimes mutually contradictory notions. (The fundamental conceptual error made by the financial establishment in failing to anticipate the 2008 crisis – and neoliberal economists and finance professors were just as intellectually, if not morally, guilty as the bankers they had trained – was that you could manage risk by parcelling it out to "those best able to bear it" or, to put this in other words, that you can generally control risk by using one kind of risk to mitigate another – e.g., offset securities collateralized by new houses in suburban Phoenix with securities collateralized by Manhattan real estate).

The motive power of the postwar Japanese financial system and the conceptual universe of the people who staffed its banks and insurance companies were precisely opposite. Both bankers themselves and the bureaucrats who oversaw what they did conceived of banks as utilities, serving the general interest. Their attitude towards risk was not to offload it to those who could best bear it (or, as with the case of the derivatives that brought on the 2008 crisis, could be tricked into bearing it), but to make it disappear. An established Japanese bank lent money to an established Japanese corporation with the understanding that risk had been eliminated. A Japanese bank did not evaluate the quality of corporate assets or the viability of business plans, and it did not run pro-forma cash flow analyses to test whether a prospective loan could be serviced even when the borrower might be under stress. Instead, it checked to see that the company was sufficiently well-connected in the Japanese power structure that failure was unthinkable. Was the company linked through cross-shareholdings and "main bank" relationships to other powerful players that would come to its rescue if things went wrong? Did it have former bureaucrats in the ranks of its "advisers" and top executives, men who had stepped down from senior level positions in the elite ministries? Did it recruit from "name" universities? A company that could not answer "yes" to these questions could obtain a constant stream of credit only if it were under the umbrella of a major company as a first-tier supplier – with the implicit understanding the larger company would bail it out if things went wrong – or if it could offer collateral in the form of land. (Until the 1990s, the Japanese policy establishment and financial community believed that real estate in Japan could never fall in price.) Everybody else was out of luck.

Japanese banks thus saw no need to set aside cushions for bad loans since loans were never supposed to go bad. Indeed, the very act of procuring a loan from an established Japanese bank formed a kind of certificate of approval that indicated a company was safely ensconced in Japan's cocoon of protection. (The first thing one did in seeking to do business with a Japanese company was to check the names of its principal bankers and then its principal shareholders. If the company had a well-known name as its "main bank" and shareholders who were members in good standing of "Japan, Inc.," the risk of default was effectively zero until the mid 1990s.)

Bank loans formed the overwhelming bulk of Japanese corporate finance.[5] Not only that, the loans were generally rolled over every year. Servicing debt thus amounted simply to earning enough to cover interest payments. The Japanese economic miracle and the vast industrial infrastructure it put into place was largely financed with short-term, revolving bank credit.

This flew in the face of every received piece of Western financial wisdom which holds that the maturity of a given type of financing should correspond to the economic life of the asset being financed. Short-term bank credit may be an appropriate financing tool for accounts receivable or perishable inventory, so goes the thinking, but assets such as factories and capital equipment with return measured in years rather than months should be financed with bonds and loans of comparable length. And the capital of the corporation itself should be financed with equity investments and retained earnings that have no maturity at all.

During the high-growth years, however, bond and stock markets were unimportant sideshows so far as Japanese corporate treasurers were concerned – and what bonds and stock were issued were generally bought by banks. The capital cushion (retained earnings plus paid-in capital) of established Japanese corporations was so low (at least into the 1970s) that it caused furrowed eyebrows in Western academic circles.

Here is where we can begin to understand the difficulty the Japanese authorities have had in creating inflation ever since it became clear in the aftermath of the collapse of the bubble that the authorities were, after all, unable or unwilling to protect all the key players in the Japanese setup. Mikuni and I had written in our 2002 book:

"It is, of course, absolutely true that accounting and disclosure requirements are indispensable to a system in which market forces determine the viability of corporations and banks. But they are also incompatible with a system in which such matters are decided by bureaucrats and their licensees in the main banks who are, in turn the principal providers of liquidity to corporate borrowers. In such a system, unprofitable borrowers can be kept alive for years – even decades – beyond the point that disclosure requirements would have automatically forced their demise. And as long as it is up to the government to ensure the solvency of corporations and banks, they need not transform themselves into profit-seeking enterprises. Profits are needed to counter risk, but the socialization of risk has been the essence of the Japanese system. Accurate disclosure is therefore not only unwelcome in this system, it must be avoided if the socialization of risk and its corollary – bureaucratic control over economic outcomes – is to be maintained...

"Japan has not developed workable procedures to recover loans because banks assumed that they would never need to use them against companies in good standing. Meanwhile, smaller companies could not get credit unless they offered land-based collateral that had, until the last ten years, always risen in price. The Japanese system really had no way of coping with the failure of large, well-connected companies, which is one reason that they were supported by the bureaucracy come what may."[6]

But of course that is what happened. Large, well-connected companies did indeed begin to fail; the policy establishment found itself unable to keep them all solvent. The most important of the failures was probably that of the Sogo Department Store in 2000. The major Japanese newspapers announced Sogo's bankruptcy with enormous black headlines of the type usually reserved for declarations of war or natural disasters that lay waste to whole cities. That the collapse of a second-tier department store could engender this level of hysteria was no mystery. For the bankruptcy of Sogo heralded the loss of independence of its "main bank," the Industrial Bank of Japan ("IBJ"). IBJ was not just any bank. It was the crown jewel of the Japanese financial system and had been the principal provider of credit to the great avatars of the economic miracle. IBJ'S absorption into the anodyne Mizuho Bank capped a series of shotgun mergers organized by the MOF and its offspring (e.g., the Financial Services Agency) that spelled the end of the familiar landscape of Japanese banking; its great names – Mitsubishi, Sumitomo, Mitsui, Fuji, Sanwa, Bank of Tokyo – mashed into each other or disappearing altogether.

In such a world, the normal process by which money is created began to short-circuit. Japanese banks had historically lent money in response to signals from the collective Japanese establishment – the MOF and other important economic/financial bureaucracies (MITI, the BOJ, the Economic Planning Agency), but also the industrial elite that could make its wishes felt through such organizations as the Keidanren, the Keizai Doyukai, the major industrial associations, and the large business groups (major companies that share the same name – e.g., Mitsubishi, Sumitomo). After the collapse of the bubble, the establishment could no longer deliver on its implied promise of keeping all favored borrowers afloat. But there was little recourse to the courts. Courts had never been allowed to play a significant role in the settlement of corporate financial distress[7]; the decision on who was kept on life support and who was allowed to fail was, like most other politically important decisions in Japan, made behind closed doors with little possibility of external review.

With land prices collapsing and lacking objective and/or accessible criteria by which bankers might determine who might and might not survive, Japanese banks essentially stopped lending to all but the most heavily protected borrowers, most of which didn't need the money in the first place. The results are visible in the monetary statistics. In 2001, Japan's broader measure of money supply (money created by the central bank plus money created through the fractional reserve system described above – the technical term is M2) fell by an eye-popping 17%, and eked along with next-to-no-growth for the rest of the decade.

The only borrower to whom the banks felt completely safe in lending was the Japanese government itself. That allowed the Japanese government to issue bonds ("JGB's" or Japanese Government Bonds) that the banks would buy; the government could spend the proceeds on enough public works to prop up demand sufficiently to keep the economy from falling into depression. (The attempt by Prime Minister Koizumi Junichiro's neo-liberal economic minister, Takenaka Heizo, in 2002 to wean Japan off of this kind of stimulus sent the economy into such a tailspin that the government quickly restored the spending life support.) But it did nothing to halt deflation. The buying and selling of government bonds – "open market operations" as they are known –

is one of the principal tools central banks have of affecting the overall money supply. (The central bank pays for the bonds it buys with newly created money and pulls money out of the system with the bonds it sells.) But in Japan, unlike the United States, virtually all JGBs are held not by end-investors but by deposit-taking intermediaries – i.e., by banks. With banks unwilling to on-lend much of the newly created money, the multiplier effect of fractional reserve banking stalls.

The economy nonetheless began to recover after the abortive detour into austerity in 2002 not because monetary stimulus succeeded in putting money into people's pockets who would then start spending it, but thanks to that old standby that had been periodically thundering onto the scene since the late Meiji period to effect economic rescue operations: exports. This time, the most important of the exports were capital goods to a booming Chinese economy that among other things was feeding an insatiable American market revved up first by the invasion of Iraq and then by the rivers of credit that Wall Street had figured out how to direct into the subprime housing market. But Japanese companies weren't using the resultant profits to invest in Japan; they either sat on them or deployed them overseas as foreign direct investment.

This all came to a screeching halt in 2008 with the collapse of Lehman Brothers and the onset of the worst global economic-cum-financial crisis since the Great Depression. The Japanese economy went into a tailspin and it was clear to the electorate that no one in a position of power in Tokyo knew what to do about it. The electorate responded by voting in an opposition government for the first time since the postwar Japanese political system had taken shape in 1955. The opposition Democratic Party of Japan ("DPJ") had campaigned on various initiatives to replace the issue-bonds-to-finance-public-works-spending tactics with an explicit social safety net modeled on that in countries like Denmark that would encourage people to spend and entrepreneurs to take risks. (Had they succeeded, the deflation problem would have disappeared. Entrepreneurs require credit and in the process of obtaining it, money is created by the fractional reserve means discussed above.) The story has been told elsewhere of how a tacit alliance of bureaucrats, the established press, and "Japan handlers" in Washington seized on the issue of a US Marine base in Okinawa to discredit and destroy the first DPJ government.[8] The earthquake/tsunami/Fukushima nuclear plant disaster derailed the second, and the third immolated itself by mishandling confrontations with China and betraying DPJ promises not to engineer raises in the consumption tax.

Enter Kuroda and his targeted 2% inflation rate. When Abe Shinzo led the old guard back into power in the Lower House elections late in 2012, he replaced BOJ governor Shirakawa Masaaki with Kuroda. Kuroda may have been an illustrious MOF graduate, but, as noted, he wasn't the MOF's choice for the job. BOJ governors coming from the MOF had, before Kuroda, all emerged from the domestic side of the MOF -- the side concerned with the national budget. They had held the position of 次官 ("jikan" or Administrative Vice Minister, generally regarded as the pinnacle of the Japanese bureaucracy) before being appointed to the BOJ governorship. Kuroda, by contrast, had been 財務官 ("zaimukan" – or Vice Minister in charge of International Financial Affairs). But Abe wanted his own man in the slot, not the MOF's nominee, and his reasons are clear. Abe sought to cement his hold on power with victory in the Upper House elections scheduled for the summer after he took office. He needed commanding majorities in both houses to begin implementing his long-held plans to remove constraints on the ability of Japan's governing elite to determine policy as it sees fit. Those constraints had originally been imposed by the American-inspired constitution and, more broadly, by a whole cluster of practices known collectively as the "postwar settlement." They include an education system stripped of militarist/nationalist and "moral" indoctrination, employment security, a pro-forma institutionalized pacifism, and theoretically independent media and judiciary. The rightists around Abe had long chafed under what they deem these "un-Japanese" arrangements; Abe's 2012 victory seemed to provide the right with its first clear path in two generations to replacing the constitution and overturning the postwar settlement. Abe first had tried it back in 2006 when he had previously held the prime ministership. But the wider electorate wasn't interested; they were mostly concerned about their economic prospects (and the government's loss of tens of millions of pension records.) Accused of being out of touch with voters' real concerns, Abe had resigned after less than a year.

He wasn't going to make the same mistake twice. If he was going to have the political space to deliver what his rightist base wanted and drive through the agenda close to his heart, he needed a short-term boost to the economy and at least a temporary sense among the wider electorate that the elusive goal of real, sustained recovery was finally in sight.

A short-term economic boost is something that a massive dose of monetary stimulus can provide in the right circumstances, and those circumstances existed early in 2013. Shirakawa could hardly have been termed a Scrooge of a central banker; the BOJ's balance sheet had expanded by some 50% during the four years plus he had been in office. But he was unwilling to attempt the kind of explosive growth in the money supply that Abe wanted.

Under ordinary circumstances, central banks are reluctant to try to push huge amounts of new money into the economy for fear of sparking runaway inflation. But these were not ordinary circumstances. Prices in Japan had not risen for some two decades. Meanwhile, not only was Benjamin Bernanke's Federal Reserve doing precisely this kind of thing to stimulate the American economy, but developed country central banks were all announcing some form of inflation target (usually, indeed, 2%). The wider intellectual and policy climate gave Kuroda the license to do what Abe wanted without being tarred as some sort of wild-eyed maverick.

Kuroda is said to be a disciple of Irving Fisher, the Depression-era American economist who famously advocated aggressive response by central bankers to the debt deflation that can follow in the wake of a major financial crisis. Whether or not Kuroda's policies would help Abe politically (and they did), Kuroda clearly believed that by announcing the 2% target and doing what he could to flood the economy with money that he stood a good chance of breaking the back of Japan's deflation. Once households and companies became convinced that the BOJ would do whatever it takes to get prices rising, they should start spending and investing, sparking a virtuous cycle. This was, of course, precisely the argument that the likes of Posen and Krugman had been making back in the late 1990s. BOJ staffers had been skeptical, for the reasons already discussed. But two things had changed since then.

First was the political landscape. Abe's 2012 electoral victory had not only provided the prime minister with a commanding parliamentary majority in the Lower House (and, indeed, Abe's Liberal Democratic Party ["LDP"] would win the summer, 2013 Upper House elections as well), but organized opposition to the LDP/bureaucrat nexus had all but collapsed. To be sure, this LDP/bureaucrat nexus had been running Japan since 1955 until the hiatus that followed the DPJ's 2009 electoral victory. But back in the 1990s, the LDP was constantly having to look over its proverbial shoulder. The LDP had briefly lost control of the Diet in 1993, and the various political groupings that would ultimately coalesce into the DPJ were already emerging. In such a climate, the LDP naturally hesitated to take measures that might improve economic efficiency but would be politically problematic – steps for example, that could make it easier for companies to fire people or remove the credit lifeline from poorly performing affiliates.

But by 2013, the implosion of the DPJ and the advent of the LDP's commanding parliamentary majorities suggested that the government finally had the political space to proceed with root-and-branch structural reform of Japanese business. Abe had promised a platform of "three arrows" to revive the Japanese economy. Kuroda's monetary policy formed the first of these arrows; fiscal stimulus constituted the second. But the third was advertised as the long-awaited unshackling of the Japanese economy from all those supposedly anti-competitive, inefficient practices that were said to be holding it back, whether those be rigid employment policies, protectionist barriers, or price supports for uncompetitive sectors. Animal spirits were supposed to revive as the more efficient companies found themselves newly empowered to focus on what they did best rather than burdened by unproductive workers and affiliates. In the process, they would see new profit opportunities from investing in Japan. Waves of domestic investment would lift wages; lending would revive as the companies turned to banks to finance the new investments. In the process money would finally begin to circulate in the amounts it should to lift the country out of deflation.

The second thing that had changed since the late 1990s was the yen. In the wake of the 1995 Mexican peso crisis, the yen had shattered postwar highs. But following joint interventions in August of that year by the American and Japanese authorities, the yen entered a period of structural weakness. By the summer of 1998, it took 145 yen to buy a dollar. But on the eve the 2012 election, the yen was even stronger than it had been back in 1995; sporadic efforts by the DPJ governments to weaken the currency had gone nowhere. Japan's traditional export champions had suffered terribly in such an environment. A wave of money flooding into the economy would weaken the yen and restore the profits of such companies, leading, Kuroda surely hoped, to a surging stock market as investors saw profitability returning to the great names of Japanese business.

This is exactly what happened. Within months of Kuroda's installation, it again took more than 100 yen to buy a dollar. The currency continued to weaken and at the time of this writing is at some 121 to the dollar. Profits at the major exporters did indeed rise, and the surge of credit unleashed by the BOJ found its way right into the stock market. The result, by the summer of 2013, was the palpable sense that the economy might indeed have turned a corner. The LDP rode the resultant wave of good feelings into the electoral victory in the Upper House elections, and then cemented its hold on the parliamentary levers of power in the snap Lower House elections Abe called for December, 2014.

But deflation has refused to go away. Part of the reason lies in events beyond Kuroda's control, or indeed the control of any Japanese government official. Drastic falls in the price of imported commodities – particularly coal and petroleum – and the interconnected slowdown of the Chinese economy have put downward pressure on prices. Meanwhile, the hurricane of reform that Abe's third arrow promised to set loose on the economy turned out to be little more than a slight stirring of the stagnant air with some empty admonitions about raising wages and hiring more women, together with musings on the supposedly transformative effect of TPP, the "Trans Pacific Partnership" being pushed by the Obama White House at the behest of Wall Street, Monsanto, the Walt Disney Company, and Big Pharma.

Kuroda has shown flashes of irritation at the unwillingness of the kantei --prime minister's office -- to be more aggressive in pushing this "third arrow" of structural reform. But more fundamental to the failure to reach that 2% target is an ingrained recoil by Japan's officialdom to any demand-stimulating measures that might shift power towards ordinary people and away from entrenched elites.

I noted above that Kuroda has been labelled a disciple of Irving Fisher. Fisher advocated direct government action to push more money into an economy in the aftermath of financial crises; he was the godfather of one of the two principal schools of postwar mainstream economics: monetarism. (Milton Friedman was arguably Fisher's most important intellectual disciple.) The godfather of the other school, the one that bears his name, was of course John Maynard Keynes, and while Fisher and Keynes may have been allies in certain respects – both strongly argued against the monetary straitjacket of the gold standard, for example, and both believed that government had the ability and must have the will to pull economies out of prolonged recession/depression – Keynes contended, to simplify things, that Fisher's approach of direct monetary stimulus was getting things backwards. Keynes maintained that in a deflationary trap, monetary expansion risks becoming a matter of pushing on a wet noodle (to use his metaphor) in the absence of aggressive measures to stimulate demand. "Printing" money will not bring on inflation in a country such as Japan where production capacity is running so far ahead of demand – or so Keynes taught. It simply accumulates in vast, stagnant pools of liquidity.

Keynes has long been anathema in the bureaucratic culture of the MOF in which Kuroda was marinated and the reasons seem obvious: Keynesian methods carry with them the whiff of a loss of bureaucratic control over economic decision-making because they address the demand side of the economy – a fancy way of saying that they work by putting money in the pockets of ordinary people so they can buy things. Reflexive elite fear of this loss of control is perhaps most visible in the way labor markets in Japan are evolving. Everyone knows that Japan's so-called "lifetime employment" system cannot survive much longer. A key element of the "postwar settlement" discussed above, "lifetime employment" took shape in response to the labor militancy of 1945-60. The waves of strikes that had characterized those years ended with a major concession by Japanese business to a key left demand: economic security. Universal "lifetime employment" may in practice have been more normative than descriptive, but major companies did end up generally providing for the lifelong economic security of their core male employees and no company – large or small – would fire anyone except in cases of criminal misconduct or extreme financial distress (firing regular employees was effectively an announcement of impending bankruptcy). This system at least in its early decades turned out to have great benefits for Japanese business as well as providing a degree of economic security for working families. Both the supply of labor (resignations were rare and poaching unheard of) and its costs (salaries rose lockstep with seniority and were effectively the same across companies and industries) became almost totally predictable while management enjoyed complete discretion over job content and location.

But the system has become an albatross around the necks of Japanese industry. As the ranks of older, more expensive, workers swell, lifetime employment protocols prevent the trimming that would otherwise occur. Labor bottlenecks are developing in key sectors (IT, for example, and construction), and younger people are losing their compunction about switching jobs. Japanese companies scramble for employees in these sectors, but are loathe to offer regular employment lest they be stuck with someone they can't fire after the bottleneck eases.

A solution that encompasses new means of providing for economic security while lifting the burden on business seems obvious. Government takes on construction of a safety net while allowing, first, a genuine labor market to take root, and secondly, re-empowering labor unions. (Labor unions have, since the early 1960s, been organized along company rather than trade lines and are effectively tools of management control.) Workers are set free to seek the best offers available while companies compete for workers secure in the knowledge than an offer of regular employment is not a promise to take care of the candidate for life. Unions negotiate better deals for the broad mass of workers. As wages rise in response both to companies bidding for talent and enhanced union bargaining power, people start spending more. Companies see households with more discretionary income and begin investing in anticipation of new demand to fill. Lending revs up to finance the investment boom, money begins to circulate and increase. Deflation ends, the economy revives, and tax receipts with it; government uses the increased revenues to finance the safety net needed to undergird the new arrangements (the DPJ's platform was something along these lines).

But this "solution" risks loss of status and income for the entrenched labor aristocracy – older workers and managers in established companies still covered by lifetime employment protocols – and it threatens loss of control by these companies over the workforce. So instead of hiring people directly, companies are turning to temp agencies, and part-time and dispatch workers for their staffing needs. The all-too-predictable result is the emergence of a two-tiered labor market: permanent employees (sei sha-in is the Japanese term) covered by lifetime employment protocols, and an increasingly larger group of people, many of them women, working for low wages with no economic security. Such people are not going to start spending in the amounts needed to lift Japan out of deflation. But the alternatives – a large pool of free agents in a genuine labor market; powerful unions speaking for the broad mass of working people – carries with it that whiff of loss of control that has always been such an anathema to Japan's elites.

Something similar can be seen in the landscape of business itself. The most profitable Japanese companies in recent decades have not been the famous names of Japanese business – Sony, Panasonic, Toshiba – but smaller firms that enjoy pre-eminent market shares in key upstream components where the purchasing decision is made not on the basis of price but quality and reliability. The German scholar Stefan Lippert has labeled such companies "hidden champions" since they are little known either to end-consumers or the investment community.[9] But this also makes them relatively invisible to the Japanese power structure. The old-line manufacturers tend to be the companies that need the crutch of a weak yen; they are the ones that hoard their earnings rather then deploy them in new investments. The hidden champions, by contrast, don't particularly benefit from a cheap yen; it mostly just increases the cost of their imports. But since many of their managers grew up in non-traditional ways – they didn't go to the "right" universities and they were not nursed by major trading companies or "name" manufacturers – their voices are not heard in the corridors of power even though one can make the argument that the companies they run provide paradigmatic examples of Japan's core competencies of reliability and meticulous attention to detail.

Absent measures that could plausibly lead to waves of entrepreneurial activity or put real money in the pockets of ordinary households, prices have gone nowhere. Signs of exasperation – even desperation – at the Bank of Japan are mounting. Kuroda pointedly said nothing in support of a splashy announcement Abe made in September of three "new" arrows of Abenomics: an unrealistic GDP target, an even-more unrealistic target to halt Japan's population decline, and a proposed safety net that lacked details either on how it would work or how it would be funded. Media accounts describe BOJ "disappointment" at reports that company unions will be seeking smaller wage hikes for the upcoming fiscal year, while Kuroda has publicly fretted that pay is not rising much, despite rising corporate profits and a tightening job market.[10] Kuroda has said he will go beyond the JGB purchases that have been the principal technical means by which the BOJ has been trying to push money into the economy. On December 25, 2015, the BOJ announced a plan to purchase some ¥300 billion in "exchange traded funds," that would target companies investing "proactively in physical and human capital" – an extraordinary initiative in the annals of central banking that calls for direct favoritism on behalf of private companies deemed responsive to political directives. Then on Jan. 29, 2016, the BOJ took the extraordinary step of announcing negative interest rates on excess reserves that banks park with the BOJ – a clear attempt to arm-twist banks into lending more.

The business press today is full of talk of "corporate governance" -- a fashionable buzzword from the West that has washed ashore in Japan over the last two years. Behind all the talk lies a recognition that Japan lacks the means that would force corporations that are sitting on piles of cash to do something with their money or face the threat of takeover and/or shareholder revolts. But actual concrete measures that would impose accountability on entrenched management make "corporate governance" seem about as empty as admonitions to hire more women. An example can be seen in the bid the Taiwanese company Foxconn made in January, 2016, for Sharp, the ailing electronics giant. If corporate governance is to have any real force, it has to allow for means by which entrenched management can be replaced by those better able to extract economic value from assets. But when it appeared that this famous Japanese name might come under the control of foreigners, a state-led consortium quickly put together a rival bid. As of this writing the outcome is still in doubt, but the almost instinctive, visceral reaction of "Japan, Inc." to a foreign bid demonstrates that for all the talk of corporate governance, Japan's traditional business and bureaucratic elite is not yet prepared for what it implies in terms of genuine accountability, whether that be to investors or other important stakeholders.

As for all those admonitions emanating from the kantei to hire more women, Richard Katz has pointed out that "(s)ince Abe came to power, the total number of women with jobs at companies has risen 6%, compared to just 1% for men… Women with regular employment at firms rose just 1% whereas those with poorly paid non-regular employment rose 10%; in other words, 91% of the entire increase in female employment at firms was in non-regular jobs (for men, regular jobs fell slightly while non-regular employment increased a bit). In short, firms are replacing regular male workers with non-regular female workers. "[11] So, yes, firms are hiring more women, but they are not hiring them for the kinds of positions that confer any kind of real economic power – or might induce them to start spending more. The paths that once led to secure, stable jobs for the majority of young men are narrowing drastically while these paths never opened up for young women. Such an employment picture does not translate into the broad revival of domestic demand needed to end deflation.

It is hard to avoid the conclusion that Japan's policy elite would, in abstract, like to see deflation disappear, but is unwilling to take steps that would actually bring that about. The reason is obvious: the most effective such steps

– bringing women into the workforce as regular employees, markets in corporate control that would break up Japan's old-line export behemoths and steer capital towards self-starting entrepreneurs and the "hidden champions," massive jolts of Keynesian stimulus directed at putting money into the pockets of urban households rather than the rural construction firms that form the LDP's base, a robust safety net that undergirds the entire Japanese population – would threaten current power alignments. This is pretty much what Mikuni and I concluded fifteen years ago in our book: that escaping the "policy trap" of our title involved a form of suicide by Japan's entrenched elites, and elites do not commit suicide.

But while we may have been right about Japan – why it is so difficult to spark inflation here, why the BOJ was reluctant to announce an inflation target, why entrenched power holders will recoil from doing what it actually takes to bring an end to deflation – we may have been wrong in giving readers the impression that these things aren't also largely true elsewhere. The European Central Bank has had no greater success than the Bank of Japan in springing the deflationary trap. Deflation may not be the challenge for the United States that it is for Japan and Europe, but the post-2008 recovery has been the most anemic of modern times. The consequences of the generation-long onslaught against American unions and the financialization of the US economy that sees most of the money created by the Federal Reserve funneled into the pockets of the 1% are now becoming obvious. Measures that could actually bring about a robust revival in demand have been blocked by entrenched elites just as effectively in Washington and Berlin as they have in Tokyo. Neither a US Congress bought and paid for by Wall Street and a cabal of reactionary billionaires nor the German industrial/financial elite have any more interest respectively in a unionized workforce with money in its pockets or Greek and Spanish pensioners with decent incomes than the rightists around Abe do in seeing millions of Japanese women with substantial, reliable paychecks accumulating real economic and political power. The share buy-backs that have goosed the American stock market in recent years are just as wasteful of earnings as the cash that has accumulated in the stagnant pools on Japan's corporate balance sheets.

In the passage quoted above, Mikuni and I wrote that "accounting and disclosure requirements are indispensable to a system in which market forces determine the viability of corporations and banks" with the implication that that is what happens in countries like the United States. But we learned in the wake of the 2008 crisis that is precisely what doesn't happen in the United States. If market forces were permitted to determine the viability of banks in my country, the major names of American banking would have disappeared and their executives would be in prison or out on the street looking for jobs. Business and financial elites in the United States and much of Europe have become as entrenched and unaccountable as their Japanese counterparts – and the Americans, for one, are far richer. Japanese executives who have run their companies into the ground at least go through the motions of contrition with low bows and ritualized apologies. Their American equivalents retire into lives of sybaritic luxury financed with severance packages so lavish the word lacks the ability to convey their scale.[12]

Perhaps the real value to outsiders of considering what has been happening in Japan is not the contrast with what goes on elsewhere, as Mikuni and I had it, but the way the country has increasingly come to function as a kind of canary in the mine of the global economy. Japan was the first to demonstrate something that is now obvious worldwide: Keynes was right. Monetary policy alone cannot loosen the shackles of a deflationary trap. We have seen orgies of credit creation by the world's leading central banks, and yet the global economy sits on the edge of a deflationary abyss as commodity prices tumble and country after country spirals downwards. Escaping this trap is going to involve a lot more than central bankers pushing money at financiers.

Recommended citation: R. Taggart Murphy, "Rethinking Japan's Deflation Trap: On the Failure to Reach Kuroda Haruhiko's 2% Inflation Target", The Asia-Pacific Journal, Vol. 14, Issue 3, No. 4, February 1, 2016.

R. Taggart Murphy will be retiring in March 2016 from his position as Professor of International Political Economy in the MBA Program in International Business at the Tokyo Campus of the University of Tsukuba. He is the author of *Japan and the Shackles of the Past* (Oxford: 2014) and, with Akio Mikuni, of *Japan's Policy Trap* (Brookings: 2002), voted the best professional and scholarly book of 2002 in the economics category by the American Association of Publishers. He is also the author of *The Weight of the Yen* (Norton: 1996), is a frequent contributor to the *New Left Review*, and has published articles in the *Harvard Business Review*, the *London Review of Books*, *Fortune*, the *National Interest*, the *New Republic*, and elsewhere.

Notes

[1] Restoring Japan's Economic Growth (Peterson Institute, 1998), p. 9.

[2] "It's Baaack: Japan's Slump and the Return of the Liquidity Trap" in Brookings Papers on Economic Activity 2: 1998, p. 182.

[3] Nippon Steel was the postwar descendent of the Japan Iron and Steel Co. Ltd, chartered by the Imperial Diet in 1934, that merged six private steel makers into the Imperial Japanese Government Steelworks that had been founded in the Meiji period. In 2012, the company merged with Sumitomo Metal to form Nippon Steel and Sumitomo Metal Corporation.

[4] At least American and British financial institutions. The "universal banks" of continental Europe historically saw themselves as closer to the utility model of their Japanese counterparts.

[5] Hamada Koichi and and Horiuchi Akiyoshi note that between 1947 and 1981, private sector banks provided from 71 to 83 percent of all external financing requirements of Japanese corporations with government financial institutions such as the Japan Development Bank providing an addition 8 to 14 percent. "The Political Economy of the Financial Market," in Yamamura Kozo and Yasuba Yasukihci, eds., The Political Economy of Japan, vol. 1, The Domestic Transformation (Stanford University Press, 1987), p. 173.

[6] Mikuni Akio and R. Taggart Murphy Japan's Policy Trap: Dollars, Deflation, and the Crisis of Japanese Finance (Brookings Institution Press, 2002), pp. 210, 212.

[7] See Frank Packer and Mark Ryser "The Governance of Failure: An Anatomy of Corporate Bankruptcy in Japan" Working Paper Series 62 (Center on Japanese Economy and Business, Columbia University, 1992).

[8] See R. Taggart Murphy Japan and the Shackles of the Past (Oxford University Press, 2014),

Chapter 11; Gavan McCormack and Satoko Oka Norimatsu, Resistant Islands: Okinawa Confronts Japan and the United States, (Rowman and Littlefield, 2012).

[9] See here.

[10] "BOJ 'Disappointed' with Meek Salary Talks," The Japan Times, January 21, 2016, p. 6.

[11] Posted at the National Bureau of Asian Research: Japan-US Discussion Forum https://japanforum.nbr.org/scripts/wa.exe?A0=LIST December. 28, 2015.

[12] The latest outrage involves Freeport, long a conservative, well-run mining company that had weathered a century of commodity booms and busts. But three years ago, its chairman James Moffett ran up huge debts to finance a plunge into the oil and gas business. With oil prices plummeting, the company is now close to bankruptcy; its stock that traded in 2010 at $60 a share is now worth $4. Moffett has stepped down, but with a severance package of $79.4 million and an ongoing arrangement that will see him paid $1.5 million as a consultant. See James Stewart "Freeport-McMoRan Battles the Oil Slump" The New York Times, Jan. 21, 2016.