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Monetary, fiscal policies must work together

Of late, the axis of the Abe administration's economic management has been conspicuously tilted toward fiscal policy. Leaders of the Group of Seven major economies agreed during the Ise-Shima Summit in Mie Prefecture in late May to advance fiscal policy in tandem with monetary policy and structural reforms. In early June, Prime Minister Shinzo Abe decided to postpone a consumption tax hike scheduled for April 2017. The government is expected to announce in autumn a new economic stimulus package to stem an economic downturn. Now that Britain has voted to leave the European Union, sending global stock and currency markets into a panic, the Abe Cabinet will likely find it more difficult to manage the Japanese economy.

How should we respond to the sudden surge in debate on

INSIGHTS *into the* WORLD

By Motoshige Itoh

fiscal policy in recent months? Are fiscal measures necessary to overcome deflation? Will Japan really be capable of returning order to its fiscal house? Indeed, many questions need answers.

In answering those questions, I would like to refer to "controlled inflation," over which there was a heated debate about 15 years ago. According to the macroeconomic viewpoint, the creation of a moderate level of inflation was considered an effective way to help resuscitate the Japanese economy that had stagnated since the bubble economy burst. At the time, the topic received extensive media coverage, and I was also involved in the debate.

The first thing we must determine is whether inflation is possible without introducing fiscal stimulus plans. Needless to say, avoiding deflation requires bold monetary measures. This was exactly the starting point for the Abenomics policy. However, the issue of whether monetary policy alone was sufficient was not adequately discussed at the time.

The Bank of Japan adopted a bold monetary easing measure by increasing the volume of money in the economy. However, this seems to have generally allowed commercial banks to increase the outstanding balances in current accounts that they hold at the central bank, instead of bringing about an upturn in personal consumption and corporate investment.

Of course, the Bank of Japan's monetary policy has played an important role in helping the country's efforts to overcome deflation, but it has stopped short of becoming instrumental in expanding demand. Against this background, the central bank resorted to a negative interest rate policy for the first time in late January. While it is too early to determine whether this unprecedented monetary policy has been a success or failure, many people doubt whether a central bank policy alone is sufficient to combat economic woes.

'Helicopter money'

Lately, a number of pundits in Japan and abroad have been talking about "helicopter money," a concept first broached by Nobel laureate Milton Freedman. He thought that central bankers could lift a flagging economy by dropping an immense amount of newly printed bills from the sky into such an economy.

How does helicopter money differ from the Bank of Japan's ongoing massive quantitative easing (QE) policy? Helicopter money does not refer to an aircraft. Instead it means that the central bank would keep printing money to purchase and perpetually hold newly issued government bonds — monetizing debt while freeing the government from redeeming such debt. In other words, the Bank of Japan would directly underwrite government bonds, a measure prohibited under the Public Finance Law because of fears that there would be no fiscal restraints.

A modest level of inflation could be effective in lowering the debt-to-GDP ratio

The main difference is that whereas under the existing QE method, the central bank buys government bonds underwritten and held by commercial banks and injects money into the banking system, the government could have helicopter money flow immediately into the economy in the form of fiscal spending.

It will be really serious if the Bank of Japan continues to hold government bonds on its balance sheet indefinitely. Then, why does the concept of helicopter money remain up in the air? There can be no other reason but to underscore the importance of implementing monetary and fiscal policies simultaneously to banish deflation.

Abenomics' main objective has been to catapult the economy from the decades-long deflationary trap since the very beginning. To do so in one go, Abe came up with "three arrows," including one for growth strategy. It remains crucial for Abenomics to deliver results with the third arrow aimed at stimulating growth, but, given the ongoing economic slump, it remains equally important to have the first two arrows — fiscal stimulus and monetary easing — work together.

For the Bank of Japan, it is far from adequate to simply repeat its QE initiative. The important thing is that the central bank should make its unprecedented policy effective in raising consumer spending, which is imperative in narrowing the supply-demand gap. If this helps boost prices and wages, QE monetary policy can become really effective in raising expectations for inflation.

Controlled inflation

On the fiscal side, it remains doubtful if Japan's fiscal system can stay robust as the Abe administration is likely to expand fiscal spending following the second postponement of the consumption tax hike from 8 percent to 10 percent. Under the circumstances, the concept of controlled inflation can be of great use. In this connection, it is important to be careful not to confound two fiscal challenges when addressing the issue of returning the country to a sound fiscal footing. One of the challenges is a near-term reduction of year-after-year fiscal deficits and the other is a long-term curtailment of outstanding government debt.

To gauge the seriousness of sovereign indebtedness, it is an international norm to calculate the ratio of public debt to gross domestic product. As it is widely known, Japan's debt-to-GDP ratio stands way above 200 percent.

Much of the numerator — ¥1 quadrillion — has accumulated due to more than 20 years of economic stagnation and deflation in the wake of the collapse of the bubble economy. It would take an enormous amount of time to trim the numerator. Even if the country managed to generate a fiscal surplus of ¥10 trillion a year, it would take 50 years to dispose of the debt aggregate. In reality, it seems almost impossible, however, to expect the country's state coffers to maintain such a sizable surplus annually in the years ahead.

The denominator, which represents the country's nominal GDP, currently stands at about ¥500 trillion. Therefore, if the GDP grew faster than the cumulative debt, the debt-to-GDP ratio would fall. For example, if the GDP continued to record an annual growth rate of 3 percent in nominal terms for 30 years in a row, Japan's GDP would be about 2.4 times larger than now. In this case, even if the overall outstanding debt remained unchanged 30 years later, the debt-to-GDP ratio would drop to about 85 percent. This hypothetical calculation points to the importance of raising GDP growth rates in nominal terms.

It is desirable that an increase in real or inflation-adjusted GDP growth rates is coupled with a rise in nominal GDP growth rates. Even when the economy posted zero growth in real terms while the consumer price index rose 4 percent, the nominal GDP growth rate would be something like 3 percent. This would contribute to paring the debt-to-GDP ratio. Therefore, a modest level of inflation could be effective in lowering such a ratio.

Primary balance

The other issue that must be tackled is the annual fiscal deficit. In this respect, it remains important for the government to attain its goal of turning into a surplus by fiscal 2020 the budget's annual primary balance — a balance between general expenditures (excluding debt services) and revenues (excluding bond-issue revenues). To that end, the government will have to raise the consumption tax rate to 10 percent without fail in October 2019, under the new schedule, and adopt a stimulus program only as a temporary measure with a view to terminating it when necessary. It is also indispensable for the government to refrain from backsliding in its ongoing efforts toward spending reforms in social security and other areas.

In the best possible scenario, the primary balance surplus will be attained at the end of fiscal 2020, followed by a further contraction of fiscal deficits, while moderate inflation is realized, and then the inflation rate will rise slightly to cause the real value of overall public debt — the debt-to-GDP ratio — to shrink. At this particular point, the concept of controlled inflation will play an important role in facilitating a healthy growth environment for the economy.

Meanwhile, it will not be easy to carry out disciplined fiscal management. Once the government eases controls on public works or social security spending, it will be very difficult to redress such spending structures. Prior to Abe's decision to delay the consumption tax hike, some people advocated that the consumption tax should be raised in April 2017 as scheduled and budgetary expenditures should be increased accordingly. In contrast, there is a more widely shared view that a delay in the tax hike — which is tantamount to being a tax reduction — is likely to have a higher quality impact on the economy than increased fiscal expenditures.

The concept of helicopter money is expected to be further and more frequently taken up. But we should stay prudent in allowing the Bank of Japan to directly underwrite government bonds. We are required to separate what helicopter money connotes — the importance of applying fiscal stimulants and monetary policy in an integrated way — and what the concept explicitly means — letting the central bank monetize government debt.

In one of my drawers, I keep a 100 trillion Zimbabwean dollar banknote issued by Zimbabwe's central bank in 2009. Trapped in an economic crisis that triggered hyperinflation that reached its zenith in 2008-2009, the African country had no choice but to print banknotes of higher denominations.

I don't think Japan will encounter an economic debacle of a similar scale. Still, we need to engage in debate over helicopter money in a precise and prudent manner.

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