

Inflation breaks Japan free from deflation trap

A wave of inflation is spreading across the Japanese economy. There is concern that inflation will grow if the U.S.-Israel war with Iran continues to cause sharply higher oil prices. How will an escape from deflation and the ensuing transition to inflation impact the Japanese economy?

Currently, both corporate earnings and tax revenues are trending upward thanks to rising prices and wages. The Japanese economy is finally breaking free from the "deflation trap," a phenomenon in which real interest rates don't fall and the economy gets stuck in a downturn.

When an economy is experiencing deflation and prices are expected to keep falling, businesses hold back on capital investments and individuals defer consumption. The result is a slump in demand, leading to a lasting cycle of economic deterioration.

The deflation trap was caused by many factors, but interest rates are the easiest to understand. Some may be unaware that real interest rates were surprisingly high when there was deflation.

Even when nominal interest rates fall close to zero, if prices go down in deflation, real interest rates stay positive. This is because the real rate is the nominal rate minus inflation. In a deflationary environment, real rates do not turn negative. When an economy is bad, lowering interest rates is a common approach in monetary policy, but a deflationary economy tends to get stuck because real interest rates don't drop.

Given the robust growth in stock prices of late, businesses are now actively making new investments and hiking wages. The shift to moderate inflation appears to be more and more favorable to the Japanese economy. But it's not yet time to celebrate. If there were, for example, a rise in long-term interest rates along with higher prices, it would increase the government's fiscal burden.

During the early stages of transitioning from deflation to inflation, the Japanese economy has

indeed benefited greatly.

The inflation rate exceeded 2% in mid-2022 and rose to 4% by the end of the year. It then hovered around an annual average of 3% from 2023 to 2025.

Over that period, there was only a limited rise in nominal interest rates, and so inflation caused real interest rates to fall deep into negative territory. This stimulated equity and real estate transactions and spurred the economy. In oth-



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INSIGHTS INTO THE WORLD

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er words, inflation freed the Japanese economy from the deflation trap, which was affected by interest rates.

But won't the negative effects of inflation be more keenly felt and its benefits diminish as it penetrates the entire economy? Given that the conflict in Iran will likely drive further inflation, now is the time to properly examine the stage-by-stage impact that the transition from deflation to inflation is having on the economy.

Impact on fiscal policy

In recent years, real interest rates in Japan have been kept at considerably low levels, largely because of the Bank of Japan's position on its monetary policy.

An inflationary trend became noticeable around 2022, but the policy interest rate was only increased gradually. For that reason, Japan's key interest rates measured in real terms were some of the lowest among major economies.

The transition to inflation also freed Japan's fiscal policy from the deflation trap. Deflation makes it difficult for the government to manage its finances. For example, the ratio of government debt to gross domestic product, an indicator of the health of public finances, tends to increase under deflation. This is because nominal GDP, the denominator in this ratio, doesn't rise. Over more than 20 years of deflation, the ratio of the government's debt to GDP had trended upward.

This changed significantly as inflation picked up. An increase in the country's nominal GDP, which rose along with prices, halted the upward trend in the ratio. Since this indicator of the health of public finances has improved, the government has found it easier to adopt active fiscal stimulus to boost the economy. Inflation thus pulled the government's fiscal policy out of the deflation trap.

However, we must be aware that with inflation becoming entrenched, its impact on the economy is about to move to the next stage.

A rise in inflation was initially effective in lowering real interest rates. But while the country's nominal long-term interest rate had been at around 1.4% until about a year ago, it has risen rapidly over the past year and topped 2.5% at the end of April. As a rise in inflation tends to gradually push up nominal interest rates, real interest rates, which had taken a sharp decline, are sure to start rising.

And though the government has gained room to maneuver since the deflation trap was beaten, its fiscal management is expected to be negatively affected by an increase in long-term interest rates as inflation becomes entrenched.

A rise in long-term rates naturally leads to an increase in interest paid on government bonds.

If interest on government bonds snowballs as projected, the government will no longer be able to allocate funds for other expenses

The Finance Ministry released a simulation in April that is very concerning. It shows how much interest on government debt would go up should the yield rise for the benchmark 10-year government bond.

The ministry's projection assumed the benchmark long-term rate would rise from 3.0% in fiscal 2026 to 3.6% in fiscal 2029, staying at that level thereafter. In this scenario, the government's annual interest payments, which are projected to total ¥13 trillion in fiscal 2026, will almost double to ¥24.3 trillion in fiscal 2030 and nearly triple to ¥35.9 trillion in fiscal 2035. If interest on government bonds snowballs as projected, the government will no longer be able to allocate funds for other expenses, which will make it difficult for the government to manage its finances.

Needless to say, a rise in long-term rates doesn't lead to an immediate spike in interest payments on the government's debt. This is because the government will only need to raise interest rates when outstanding government bonds issued with very low rates reach their maturity date. As the Finance Ministry simulation shows, interest payments are projected to rise over time, from fiscal 2030 to fiscal 2035, meaning there is a lag before rising interest rates lead to higher interest payments. But this reprieve will be short.

To reiterate, the Japanese economy is seeing major benefits after escaping from the deflation trap. However, once long-term interest rates rise as inflation takes hold, such benefits will eventually vanish.

How high will long-term interest rates rise? I have no answer to this question. However, looking at long-term interest rates in the United States, the United Kingdom and other countries going back 200 years or so, while there are variations depending on the era, they averaged just over 2% in real terms. This means that the nominal interest rate could be about 4% if inflation stands at 2%.

Over the past 20 years or so, interest rates have declined, deviating from this trend. Japan is no exception. Low interest rates have undeniably lowered people's awareness of fiscal risks.

And concerning, the situation in Iran and other factors could push up inflation, forcing a further rise in long-term interest rates. Given these factors, it has become even more important that we remain vigilant against fiscal risks.

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