Opinion **Global Economy**

Fears of Japanification spreading are misplaced

The country's quirks make similar deflation for the US and Europe a stretch

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Japan's coronavirus-induced decline into recession that was revealed this week is a sorry outcome given Prime Minister Shinzo Abe's protracted efforts to arrest years of economic stagnation. The annualised economic shrinkage of 3.4 per cent in the first quarter follows a 7.3 per cent contraction in the last quarter of 2019.

It is also sobering for western investors who fear Covid-19 may herald a Japanese-style future for the US and European economies. That would imply continual dependence on fiscal and monetary pump priming to fight endemic deflation, at the cost of ever bigger government debt: Japanification, in a word.

There can be no denying that there are common symptoms in the other advanced economies that make the notion of Japanification resonate. Yet common causes are another matter.

When recovery comes, thanks to unprecedented fiscal and monetary measures, lockdown's self-imposed decimation of the supply side of the economy points to potential bottlenecks and upward pressure on prices in some sectors. Yet pricing in bond markets points to zero inflation over the longer run. Any upturn will also likely be subdued because of risk aversion. In the corporate sector, heavily indebted companies will give priority to paying down debt and rebuilding balance sheets. Households will also be cautious, after the trauma of devastating unemployment.

To assume Japanese-style deflation for the US and Europe is nonetheless a stretch because of some very quirky aspects of Japan's performance since the bursting of the bubble economy in 1990.

Economists tended to assume that as the Japanese population aged, private savings would fall because the elderly consume most or all of their retirement incomes. This has not happened. While households have indeed run their savings down, the decline has been - offset by a huge increase in corporate savings.

To mitigate the deflationary impact of excess savings and inadequate consumption, the government has run deficits that have caused net debt of 154 per cent of gross domestic product, the highest in the developed world.

The corporate sector was able to rack up this saving, despite a marked loss of global export market share and a decline in innovatory spark in recent years, because of the labour supply shock arising from the entrance of China and other emerging markets into the global economy. For the past 30 years this put a lid on wages in advanced economies, including Japan. Equally important, as Charles Dumas of TS Lombard points out: "The combination of a plunging world market share and very high profit margins has only been possible with wage rates falling relative to output, incomes and gross business profits."

Things will be very different in North America and Europe. While it is true that savings exceed investment in the German and other northern European economies, the benign environment for corporate profitability is almost certainly over. US President Donald Trump's trade wars have brought deglobalisation, which increases costs. Covid-19 is also forcing business to strike a different balance between efficiency and resilience, with the same result.

In the post-pandemic world, society may reassess the value of poorly paid jobs that put workers' lives and health at risk. A political backlash against insecure employment in the gig economy seems probable. Much of the higher taxation needed to shrink burgeoning public debt will be paid by the corporate sector. At the same time, business is under growing pressure to adopt more inclusive policies towards employees and society at large.

Furthermore, in a forthcoming book economists Charles Goodhart and Manoj Pradhan argue that the balance of bargaining power is swinging back to workers, away from employers, not least because workforces in the west are set to shrink or are shrinking already. The stage is thus set for a very un-Japanese distributional struggle in which workers exercise power through the labour market while the elderly fight back via the ballot box.

Meanwhile, the disinflationary bias in monetary policy over the past 30 years of independent central banking is at an end. In responding to the coronavirus-induced recession, central banks are co-operating with governments. Quantitative easing — central bank asset buying — did not lead to inflation after the financial crisis. That is because the injections of liquidity mostly stayed in the banking system in the form of excess reserves, held by banks at the central bank.

Today's policy measures, in contrast, are putting cash directly into industry and commerce, which affects broader money and thus inflation.

It will be very hard for governments to retreat from fiscal largesse when unemployment remains high and many over-indebted companies will still be at risk. And given the fragility of debt-burdened economies, central banks will be reluctant to raise interest rates to combat inflation for fear of killing recovery and jeopardising their independence.

Despite the insouciance of the bond markets, everything points not to Japanification but to a resumption of inflation. The only question is one of timing.

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