

Discussion Points for Assignment #2 – Question #3

3. Is Japan caught in a downward deflationary spiral?

Start with a discussion of what deflation (and a spiral) is, why it is bad, and if Japan is really experiencing it:

1. Deflation is when wholesale prices fall instead of rise (inflation) from year to year. This causes money to be worth less next year than it is today.
2. A downward deflationary spiral is when falling prices lead consumers to delay spending in anticipation of lower prices. The reduced spending (lower demand) leads to lower corporate revenues which causes them to layoff workers. More unemployment leads to even lower demand causing prices to fall even further.
3. Deflation is a problem because in addition to leading to a possible spiral, it inflates the real burden of debt (it becomes greater year to year), and makes monetary policy ineffective. In a sense, the government loses control of the economy. Capitalism doesn't work during deflation.
4. Japan is certainly experiencing deflation. Consumer prices have fallen for two years in a row and the consumer price index also contracted last year. The gross-domestic-product deflator has also slid two straight years.

Next talk about what caused the deflation in Japan:

1. Major reason is that Japan is being crushed by debt. Both consumers and corporations currently have an unbearable debt load (greater than all of their positive assets). This causes banks to be stingy with loans and decreases investment exasperating the problem.
 - a. Such large debt loads were caused by bubble in 1980s on asset prices. When the bubble burst, many were left with almost worthless properties but still shouldering a large debt.
 - b. Corporate structures are also to blame. Most companies are financed by debt instead of equity. This only adds to the problem during a recession.
2. Japan has historically used their trade surplus to avert economic crises. Since they are an export-led economy, using the currency value to manipulate the surplus could often stave off a recession. Their economy has since dwarfed their trade surplus rendering their primary economic tool ineffective.

Now a few sentences about what Japan could do about the deflation and if they are actually caught in a spiral or not:

1. Yes, they are caught in a downward deflationary spiral:
 - a. The usual expansionary policies have been in place for almost a decade and have done nothing to help the economy. They have increased government spending (itself to a huge debt), dropped interest rates (almost to zero), and expanded trade but the economy is still mired at the bottom.
 - b. Current cultural sentiment precludes people from declaring bankruptcy which prevents them from eliminating their debt.
 - c. There is never a real easy way to get out of deflation. It took a world war for the US to come out of its deflation.
2. The major thing Japan can do to curb deflation is to eliminate the debt – then all the other stimulus policies will start to show an effect:
 - a. Japan needs to find a way to allow people and corporations to declare bankruptcy and to eliminate the debt. They need to allow banks and corporations to fail and they need to bail out individuals by inventing bankruptcy laws. They also need to throw a bunch of people in jail to hold them accountable for causing this mess. Without debt restructuring, investments, consumption, and growth will remain low.
 - b. Corporate financing should switch from debt to equity financing. This will remove the burden of debt and will force companies to start focusing on profits making them more immune to a recession.
 - c. The Japanese need to start printing money (once the debt is cleared). More money will lead to inflation which will make monetary policy effective again and lead to increased investments which will drive GDP growth. It will also devalue the currency driving greater exports.

The deflation in Japan cannot be attacked directly and must be controlled through these methods. These economic changes, however, will require a significant shift in Japanese cultural attitudes. Bankruptcy is not acceptable in current sentiment and much of the stigma from declaring bankruptcy must be removed before people would be willing to do it. However, the *only* way Japan can escape the deflationary spiral to is eliminate the public and private debt. It might help to call it something else (like debt refinancing), but doing this is vital to stopping deflation and regaining control of the economy.

Other points lots of people talked about:

1. Printing money – many people said that the government should just print money as a means of driving inflation and devaluing the yen (thereby increasing exports). This policy would be very effective in an economy that is not experiencing deflation. However, during deflation, any extra money is likely to be held by consumers and taken out of circulation because of their low propensity to consume. Consequently, the anticipated supply effects of inflation and devaluation would not occur. It would just increase the stockpile of money that people keep in their houses. Once deflation is halted, though, this policy is very effective as people have an incentive to spend and thus drive up inflation and money supply.
2. Increasing exports – it was also argued that Japan should focus on increasing exports (through yen devaluation or cheaper prices) but the Japanese have already doubled their trade surplus in the last few years without seeing much benefit. The problem is that the Japanese economy has outgrown any effects of the trade surplus – the economy has dwarfed the surplus so this strategy has worn out. An increasing of the trade surplus may help the economy a little but not enough to bring them out of deflation.