With Fiscal Expansion in Response to the Coronavirus, Abenomics 2.0 Can Bring Japan Out of Deflation

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With the “coronavirus shock” creating what can be considered Japan’s worst postwar economic downturn, the government has further shifted away from its former austere mindset with regard to fiscal policy and embarked on even larger fiscal stimulus to overcome the crisis. Nevertheless, there are strong concerns over a coronavirus-induced economic downturn, and even after the coronavirus shock is overcome, the path toward renewed economic recovery and an exit from deflation is unclear. What kinds of economic policies should be pursued? What is needed to avoid an L-shaped economy? What is necessary to advance from a sluggish U-shaped recovery to a more rapid V-shaped recovery? In a solid economic recovery, how do we return to the path of exiting from deflation?

There are three cycles that determine the shape of an economic recovery and a complete exit from deflation – credit, capital expenditure, and reflation. The first thing that needs to be done is a full mobilization of economic policies, both fiscal and monetary, to raise the credit and capex cycles. Then, continuing with a strong policy mix of fiscal expansion and monetary easing, if Abenomics 2.0 swings the reflationary cycle to the upside, something that was missing from Abenomics 1.0, it may be possible to finally pull Japan completely out of deflation. With a strong policy mix of expansionary fiscal policy and monetary easing, the bottlenecks that have been impeding the expansion of the monetary economy and preventing inflation from picking up have started to be resolved. The same could be said about the United States and Europe. Removing the bottleneck could change the direction of the global deflation that has been a weight on economic activity to date, to inflation that accelerates and stimulates economic activity.

Why Has Japan Persistently Remained in a State of Deflation?

For many years, prices in Japan have continued to decline on the lack of expectations for future economic growth. This has meant companies have emphasized restructuring and other cost reductions rather than investment. Wages have declined, putting pressure on household income. In a normal economy, companies procure funds to develop and expand their businesses. Corporate borrowing means they have a negative corporate savings rate (i.e. there is demand for funds by businesses). In Japan, however, companies are following the pattern of households and curtailing outlays and striving to save, continuing to repay debt as a deflationary hedge. This has caused the corporate savings rate to become abnormally positive (i.e. there is no demand for funds by businesses). If businesses that normally demand funds stop demanding funds, outlays decline and put downward pressure on domestic demand. As a result, since the bursting of the economic bubble around 1990, Japan’s economy has been plagued by weak domestic demand and deflation. If companies are having the effect of depressing demand, the government could step in and increase demand. Interest rates have remained extremely low because the lack of fund demand by corporates is indirectly supporting the financing of large-scale government outlays.

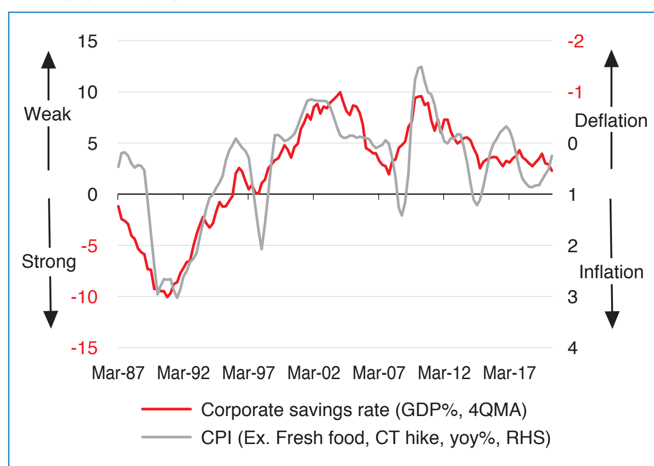
By not escaping from the old mindset that fiscal deficits during periods of corporate demand for funds (when corporate savings rates are negative) create the risk of high interest rates, the government has continuously been half-hearted in its fiscal expansion policies. In addition, with economies overseas showing strength, as soon as Japan’s economy begins to improve the government has raised taxes and implemented austerity measures before the economy completely escapes from a state of weak domestic demand and deflation. With this type of contractionary fiscal policy, the safety net to rescue the weak disappears and leads to a negative cycle, with declining wages strengthening households’ concerns regarding the future, which in turn weakens demand, which in turn shrinks the size of the business pie, which causes companies to pursue further restructuring and cost cutting, including wages, rather than investment. As a result, concerns about declining wages, shrinking business pies, and declining prices from weak demand become entrenched in the economy *(Chart 1)*.

Launch & Stalling of Abenomics 1.0

Abenomics 1.0 was launched in 2013 with the aim of pulling Japan completely out of deflation. The Bank of Japan (BOJ) moved forward with unprecedented large-scale monetary easing. Interest rates fell to practically zero. The large amount of funds available to financial institutions strengthened a sense of reassurance among small and medium-sized companies (SMEs) that they could procure funds whenever they needed it to an extent never seen before. The BOJ Tankan financial institution lending attitude diffusion index for small enterprises and leading indicator of the unemployment rate, rose to by far its highest level since the bursting of the economic bubble, indicating a strong upswing of Japan’s credit cycle. At the

CHART 1

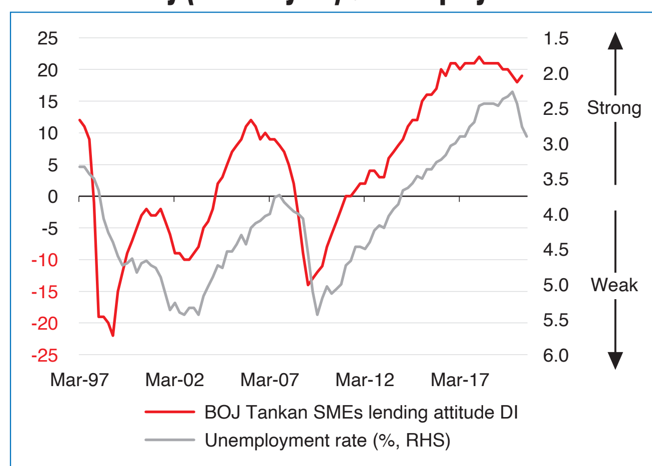
Corporate savings rate & Consumer Price Index



Sources: Bank of Japan, Cabinet Office, Ministry of Internal Affairs and Communications, Société Générale Securities Japan Limited

CHART 2

Diffusion index for lending attitude toward SMEs in BOJ Tankan survey (credit cycle) & unemployment rate



Sources: Bank of Japan, Ministry of Internal Affairs and Communications, Société Générale Securities Japan Limited

same time, Japan's economy had been undergoing a shift from a focus on manufacturing industries to service industries, partly driven by the developments in information technologies. The reassuring sense that funds could be procured at any time lowered the need to carry cash on hand and other idle funds, and instead increase investment. This helped to accelerate the growth of new businesses and services. At the same time, the large amount of funds available helped to increase hiring, driving the unemployment rate to by far its lowest level since the collapse of the bubble economy.

This period also had a tailwind from strong economies overseas. Fiscal policy, which was starting to be reined in after an expansionary period for the recovery from the 2011 Great East Japan Earthquake, was bolstered by proactive outlays at the start of Abenomics 1.0, adding to the recovery in demand. Nevertheless, with concerns of an aging population far into the future and the economy showing a bit of strength, taxes including the consumption tax and social insurance premiums were raised and austere fiscal policies were introduced before the economy completely exited from a state of weak domestic demand and deflation. This caused Abenomics 1.0 to stall *(Chart 2)*.

Exiting from Deflation Requires Expansionary Fiscal Policy

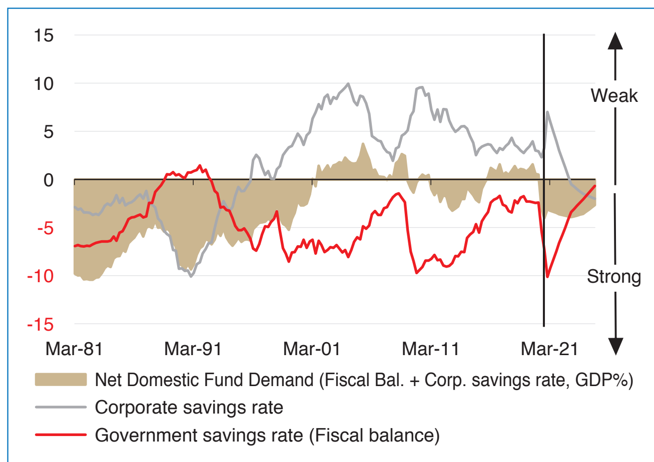
If solid economic growth is to be maintained even with weak corporate spending and demand, government spending could offset such weakness. With fiscal policy having turned austere, however, the abnormally high level of positive corporate savings rates could not be offset by fiscal spending. As a result, net domestic fund demand (the corporate savings rate plus the fiscal balance), which should be negative (i.e. excess fund demand), declined (spending was weak). Net domestic fund demand is the force that drives the creation of money by increasing the flow of money and growing the monetary economy. Money flowing through the economy includes household income increasing. However, the reduction in net domestic fund demand meant that the reflationary cycle (the monetary economy's strength to expand) was weak. With money not expanding, there was no real sense of an economic recovery. A contractionary fiscal policy placed a major burden on households. Concurrently, weak spending by companies and the government translated to tepid wage growth. As a result, this kept demand weak and prevented the economy from completely exiting from deflation.

Furthermore, the lack of net domestic fund demand made it difficult for the liquidity provided by the BOJ through its monetary easing programs to have a positive impact. The lack of fund demand caused money injected to remain in the financial institutions' current account balance at the BOJ. This limited the effect of the BOJ's quantitative easing program.

The slowing flow of funds to households, combined with the burden from contractionary policies including the consumption tax hikes, increased dissatisfaction among the voting public. This led to populist-style policies to emerge and confidence in the government to weaken. Furthermore, over-relying on monetary policy in light of a lack in net domestic fund demand exacerbated the negative side effects of monetary easing policies such as increasing the pressure on the management of financial institutions in a world of prolonged ultra-low interest rates.

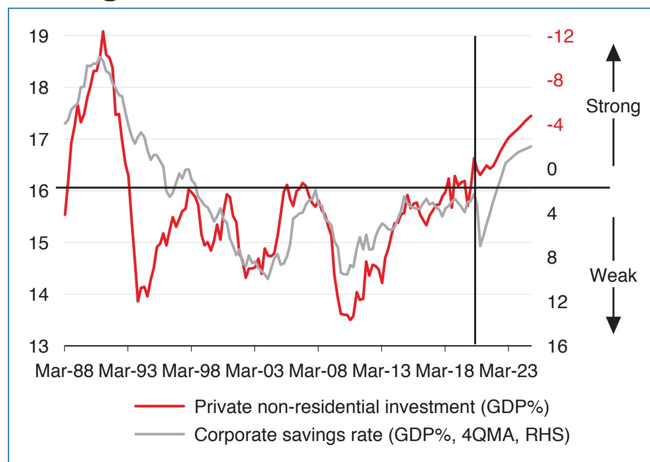
As long as the net domestic fund demand does not grow to the huge extent seen during the bubble period (roughly 10% of GDP), major problems such as spikes in interest rates or the government crowding out private investments as they compete for funds should not materialize. The need for immediate contractionary fiscal policy

CHART 3
Net domestic demand for funds
(reflationary cycle)



Sources: Bank of Japan, Cabinet Office, Société Générale Securities Japan Limited

CHART 4
Capital investment cycle & corporate savings rate



Sources: Cabinet Office, Bank of Japan, Société Générale Securities Japan Limited

should not strengthen either. However, a complete exit from deflation was hindered by simple concerns over the size of the fiscal deficit and government debt. This led to a mistaken contractionary fiscal policy to be implemented, which did nothing but reduce the net domestic fund demand, the power to reflate the economy. Bolstering a reflationary cycle and emerging from deflation require inducement of an appropriately large net demand for funds *(Chart 3)*.

Budding Exit from Deflation

Even though the gears are moving slowly, the move toward a complete exit from deflation is continuing. The credit cycle has swung to the upside and the size of the business pie (i.e. nominal GDP) is gradually beginning to expand. Wages and prices have also begun to trend upward. Against this positive backdrop, if expectations for strong future economic growth accompanied by higher prices increase, corporate investment should increase as well. This would create an opportunity for an exit from a state of persistent weak domestic demand and deflation. Previously, private sector investment had been unable to rise above 16% of GDP (the size of the economy), indicating investment activity remained weak. However, over the past few years, the ratio has surpassed 16% continuously for the first time since the collapse of the bubble, indicating that investment activity has started to increase. Japan's capex cycle has finally turned upward.

These are the buds of emerging from deflation. Companies are experiencing labor shortages, and the need to rely more heavily on capital is increasing. This has helped to accelerate the development of new technologies including artificial intelligence (AI), the Internet of Things (IoT), robotics, big data, and 5G. Budgets for urban redevelopment and for research and development are also growing. Businesses are also rolling out new products and services. Japan's businesses are looking to expand.

With the capex cycle leading the way, over time the corporate savings rate should return to a normal negative level (reviving demand for funds by Japan's businesses) from the current abnormal positive level. This in turn should help remove the downward pressure on aggregate demand. The demand for funds should accelerate the flow of money and cause money to expand. As a result, Japan should be able to exit from its persistent state of weak domestic demand and deflation *(Chart 4)*.

Exiting from Deflation by Way of Fiscal Expansion

However, Covid-19 has hindered the exit from deflation. The pandemic has heightened concerns of an economic downturn, bringing household and corporate activity to a standstill, and created renewed uncertainty about whether the economy will be able to rebound and exit from deflation. The top priority of the government's and BOJ's economic policies is to not stifle the credit cycle. If the credit cycle is not impeded during the crisis and the expansion mechanisms seen to date for business and hiring are maintained, the economy will be able to rebound as the pandemic abates and avoid falling into an L-shaped recovery.

With the momentum for new technological development continuing during the pandemic and support from the government's economic policies remaining strong, the accelerated push for new information technology and innovation should spur further innovation in the future. As a result, if the capex cycle further swings to the upside, indicating the further revitalization of investment activity, the economic recovery post-Covid-19 will shift from a gradual U-shaped to a more rapid V-shaped recovery. At this point,

TABLE 1

Shapes of the economy from the new coronavirus pandemic

Shapes of the economy
I-shaped (continued decline): Collapse of economic structures due more to the epidemiologic issue of an explosive spread of infections than to economics
L-shaped (bottoming out with no recovery): Companies re-embark on deleveraging and restructuring, the environment for hiring and incomes worsens, leading to a return to deflation
U-shaped (gradual recovery): Economy recovers gradually supported by a strong hiring and income environment, but emergence from deflation remains far off in the absence of additional forces to boost the economy
V-shaped (immediate return of recovery strength): A strong economic recovery on growth in corporate capital investment driven by things like new information technologies. Return to original path of emergence from deflation on strength of policy mix of fiscal expansion and monetary easing.
W-shaped (2nd drop on re-emergence): Epidemiologic issues including whether or not vaccine is successfully developed or herd immunity achieved, or risk of virus mutation

Source: Compiled by the author

TABLE 2

3 cycles & shapes of the economy

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① If the **credit cycle (diffusion index for lending attitude toward SMEs in the BOJ Tankan survey)** does not stall, **the economy avoids an L-shape and proceeds to a U-shape**.
② If the **capital investment cycle (real capital investment as percentage of GDP)** rebounds, **the economy changes from a U-shape to a V-shape**.
③ If the **reflationary cycle (net demand for funds)** picks up, **Abenomics 2.0 is operating**.

Source: Compiled by the author

the economy should fully return to its previous path toward a complete exit from deflation *(Table 1)*.

To this point we have looked at how the reduction in net domestic fund demand, the driving force behind the expansion of money and the monetary economy, led to a weak reflationary cycle and hindered the Japanese economy from exiting from deflation.

However, facing what can be considered the worst postwar economic downturn, the government has put aside the conventional thinking that "fiscal deficits always strengthen the risk of higher interest rates", and has embarked on a series of large-scale fiscal stimulus to overcome the crisis. With fiscal expansion and corporate activity reviving, net domestic fund demand, the force that creates aggregate demand by increasing the flow of funds in the economy, should pick up. In other words, the reflationary cycle should swing to the upside. With the BOJ monetizing this revived demand, Abenomics 2.0 should start to operate.

Through a continued policy mix of large-scale fiscal expansion and monetary easing, Abenomics 2.0 should accelerate the upswing of the reflationary cycle, something missing from Abenomics 1.0, and return the economy toward completely exiting from deflation.

With corporate savings rates returning to their normal negative level in a few years, excess savings will no longer depress aggregate demand. That said, as long as the reflationary cycle remains weak, the revival of corporate activity will remain weak regardless of how impressive the government's growth strategy is. If Japan's reflationary cycle is first raised through fiscal expansion and money starts to grow again, companies will likely react by increasing their spending. This would pave the way for the government to declare that Japan has completely emerged from deflation. The government will likely declare a complete exit from deflation when the corporate savings rate returns to its normal negative level, i.e. when the downward pressure on aggregate demand is eliminated and the risk of returning to deflation even during the next recession is also removed *(Table 2)*.

The ideal level of net domestic fund demand can be seen as roughly 5% of GDP (¥30 trillion). Considering the large rise in the corporate savings rate due to Covid-19, fiscal expansion to date is now finally at a level sufficient to revitalize net domestic fund demand. Thus, the risk that Japan's fiscal situation remains unstable is low. With net domestic fund demand not overheating, there is still much room for fiscal expansion to provide further support for households and companies and bring about a V-shaped economic recovery. Maintaining an accommodative fiscal policy (maintaining the increased level of fiscal outlays) to keep the desired level of net domestic fund demand until the economy emerges from deflation will be critical.

Japan's fiscal policy stance until recently has been to adjust the fiscal balance so that net domestic fund demand remains around 0%. However, such a policy stance is too constrictive for the economy. Instead, the government should aim to guide net domestic fund demand to roughly 5% of GDP. In other words, fiscal spending could increase persistently by around 5% of GDP (¥30 trillion) on the assumption that the cyclical elements of fiscal policy do not change. In light of Covid-19, the government seems to be using that available surplus. In the future, once programs aimed at problems surrounding Covid-19 can be reduced, the increase in spending could be shifted to other programs such as education, infrastructure investment, support for households (programs like a basic income), and the expansion of the medical and social welfare structures.

One material risk that remains is policy makers shifting back to an austere fiscal policy stance prematurely on the back of a simple reactionary mindset to the latest fiscal expansion, and the underlying belief that the size of the fiscal deficit and government debt poses a significant risk. Such moves could return fiscal policy to one that aims to excessively constrict fiscal spending, and suppress the revival of net domestic fund demand, hindering the move to

completely exit from deflation.

A coronavirus tax, similar to the taxes introduced to fund the recovery from the 2011 earthquake, or another increase in the consumption tax would cause major damage to the economy and households. An ideal way to reduce the deficit and debt would be to stimulate corporate activity and bring the corporate savings rate down to roughly 5%. The revival of private economic activity would lead to a natural increase in tax revenue with fiscal tightening used to control the overheating of private demand. Fiscal soundness through economic growth would reduce the fiscal deficit while maintaining a desired level of net domestic fund demand. The failure of Japan's economic policy and the resulting decades of deflation were due to excessive savings in the economy, primarily from an abnormal positive corporate savings rate and insufficient demand. Policymakers will need to recognize their past mistakes that excessive emphasis on a contractionary fiscal policy, such as a focus on a neutral fiscal balance, reduced the net domestic fund demand excessively, which depressed the reflationary cycle. This exacerbated and prolonged Japan's deflation and an economic downturn. With corporates and governments not being in their natural state, households were forced to carry the burden of these mistakes.

The Shape of Inflation After the Pandemic

To forecast the direction of prices after Covid-19, one needs to look closely at the differences in the trends, rather than at short-term variables. For the near future, there will continue to be a sense of caution with regard to the spread of Covid-19 and the government will continue to call for containment measures, which will press on economic activity. This will cause the recovery in demand – and for services in particular – to be gradual. In the absence of major physical damage to the supply side (e.g. manufacturing facilities and supply chains) like that seen in the aftermath of the 2011 earthquake, the supply side of the economy will remain intact. Thus, a state of excess supply will put downward pressure on prices. However, at the same time, lower prices will increase households' real incomes, which in turn will help support demand. Normally prices drop when demand weakens compared to supply.

However, post-Covid-19, the state of excess supply will likely disappear. With people's lives returning to normal, demand should recover. Furthermore, solid hiring and household income remaining firm should further help demand to recover.

In light of Covid-19, there is a possibility that businesses will reassess the risks they carry in terms of their current global manufacturing structure. In order to become more resilient to future shocks of a similar nature, businesses could shift and diversify their supply chains and manufacturing processes. In exchange for more stable supply chains, including more inventory stockpiles as a form of crisis management, businesses could demand a premium. At the same time, awareness of social distancing and other measures to prevent the spread of Covid-19 will constrict supply, primarily for services. Companies will emphasize maintaining their profit margins over just sales volumes or market share. Thus, businesses will become less willing to cut prices as a response to temporary weakness in demand, making price elasticity more inelastic. A persistent state of excess demand could further accelerate the shift from deflation to inflation.

The strength or weakness of inflation in the post-Covid-19 world could be completely different depending on whether decisions are made with or without taking net domestic fund demand into account. A continued shift in fiscal policy from contractionary to expansionary would bring about a change from the deflationary trend to date to a trend of inflation, especially under a policy-mix approach.

The government and the BOJ have been greatly expanding their policy of providing liquidity to companies under a policy of making an all-out effort to protect the credit cycle. With the latest data indicating a continued upswing in the credit cycle, an L-shaped economy has been avoided. Meanwhile, capex continues to significantly outperform real GDP, keeping the ratio of real non-residential investment as part of real GDP at a post-economic bubble high. Although near-term business sentiment has taken a hit, businesses' need for greater productivity remains intact, in part driven by tighter labor supply from an aging population trend.

With companies having determined that the effect of Covid-19 will be temporary and with funding remaining available as financial institutions' lending attitudes remain strong, there is no reason for businesses to significantly shrink their capex. Thus, Japan's capex cycle will likely remain swinging to the upside. If capex remains strong even after Covid-19, it will further strengthen the economic recovery created by a robust credit cycle. The capex cycle will help the recovery shift from a gradual U-shape to a more rapid V-shape. Furthermore, even though Prime Minister Shinzo Abe has resigned, his successor, Prime Minister Yoshihide Suga, will likely carry on the general policy framework of Abenomics of pulling Japan completely out of deflation and stagnant growth. Even with the change at the top, Abenomics 2.0 will likely start as Covid-19 settles down.

Global Strength for Inflation

Similar to Japan, countries around the world have embarked on huge fiscal expansion to cushion the effects of Covid-19 on their economies. Fiscal deficits have grown significantly across the world. With strong policy mixes of fiscal expansion and monetary easing, major economies, including Japan, the US, and the Eurozone have all but eliminated bottlenecks for money to expand. The possibility has emerged that the global economy will experience inflation, which supports the further expansion of economic activity, instead of deflation, which weighs down on economic activity.

In the US, with a growing fiscal deficit combined with a small increase in the household and corporate savings rates, the current account deficit will grow. A current account deficit would mean that the supply of dollars, the key currency in the global economy, from

the US to the rest of world will expand. An increase in the US current account deficit combined with the Fed continuing its monetary easing policies will further expand the global supply of dollars. To date, the US's net domestic fund demand has remained strong, but as corporates saved and the government reduced the fiscal deficit, net domestic fund demand shrank. However, as households deleveraged after the crash of the housing bubble and increased their savings, the current account deficit shrinking over the same period acted as the counterbalance. In Japan, against the backdrop of the problem of excessive corporate savings, a contractionary fiscal policy has failed to offset excessive savings. This has led to aggregate demand being depressed and has been one of the main factors behind Japan's deflation to date. Today, a policy mix of fiscal expansion sufficient to offset excess corporate savings and monetary easing monetizing net domestic fund demand is reviving the expansion of the monetary economy. Stimulating net domestic fund demand could also eliminate the bottleneck preventing funds from flowing to households and hindering the pick-up in private consumer demand. Even with the decline in net domestic fund demand, Japan's current account balance has remained stable. Instead, households' savings have declined significantly, indicating that households instead of the global economy have taken on most of the burden of the decline in net domestic fund demand.

In the Eurozone, rather than households, the effect of the decrease in net domestic fund demand appears to have been passed on to other countries in the form of a large increase in the international current account surplus. In the Eurozone, strong underlying expectations for inflation are making it difficult to reduce wages. Furthermore, the euro has remained at a level which has exacerbated the current account surplus for export powerhouses such as Germany. Stimulating net domestic fund demand through fiscal expansion could begin to reduce the large current account surplus, which grew rapidly by taking demand from other countries, as domestic demand revives.

In all three economies, the policy mix and the subsequent expansion of money could lead to a rise in asset prices and trigger a shift from a global deflationary trend seen so far to a global inflationary trend.

Consequences of Power Struggle Between US & China

Even after Covid-19 calms down, markets appear to have a sense that the struggle between the US and China for global political and economic supremacy remains a source of uncertainty. Within the economic environment of global deflation, China has grown to become an economic superpower. Will it be able to maintain that strength even after the global economic environment becomes inflationary? Is China's state capitalism more efficient than the free market capitalism of Japan and the US, and effectively able to control inflationary pressures?

Global deflation – an economic environment characterized by excessive savings (a surplus of capital) – allows for inefficient state-directed investment activity. These policies which partially increase aggregate demand artificially through inefficient policies can be seen as having the power to expand the economy. However, a global inflationary economic environment calls for more efficient investment activity. This could potentially cause state-directed economic structures that incorporate structural inefficiencies to become considerably inferior to free-market capitalist economic structures that incorporate autonomous, effective mechanisms. Thus, in order to win the battle for global political and economic supremacy, US policymakers could prefer a more advantageous global inflationary economic environment.

Another reason that free market capitalist economies can gain supremacy through inflation is their ability to export their own currency. By running a persistent current account deficit, the US provides dollars to the rest of the world. This increase in the supply of dollars could trigger a rise in asset prices, leading to a turnaround in the global deflationary trend to date to a global inflationary trend. However, state-run economies like China that also worry about potential capital flights will have a hard time exporting their currencies. If the yuan becomes a global currency, it will risk creating an economy that will have to run a persistent current account deficit, something state-run economies cannot manage effectively. Thus, the ability to maintain a dollar-based key currency system through free movement of dollars in and out of the US gives it a key advantage in this struggle for global economic supremacy.

A considerable amount of time will be needed before clear signs of global inflation appear. Remaining in a mindset of persistent global deflation could raise the risk of failing to recognize the shift toward global inflation as a result of changes in the global economic environment, including policy interventions by various governments. A global change in direction from deflation to inflation could provide a strong boost to Japan as it moves to completely exit from deflation. The fact that the risk of uncontrollable inflation remains small will allow Japan to maintain its policy mix until the very end and to solidify the shift to a path of sustained economic growth. Nevertheless, a premature shift back to contractionary fiscal policies after Covid-19 is contained, driven by excessive fears regarding the state of government debt, could change the current tailwind to a major headwind. JS

Takuji Aida has been Chief Japan Economist at Société Générale Securities Japan since August 2013 and has been highly ranked in various economist rankings. He has extensive experience as an economist at several financial institutions such as UBS Securities Japan, Brevan Howard (Japan), Barclays Capital Japan, and Merrill Lynch Japan Securities.