Living with Deflation

By Hatakeyama Noboru

According to the statistics published last October, the retail price index of Japan has been falling for 49 months in a row. In light of this, some economists, domestic or foreign, may again raise those voices recommending the Japanese government adopt an "inflation targeting policy." Needless to say this policy is the one that tries to artificially induce modest inflation to cope with deflation. Until a year ago or so, I frequently encountered such opinions from American professors whenever I visited the United States.

In Japan, there are many politicians wondering why Japan alone has been suffering from falling prices for such a long period of time. Trying to solve this problem, some of them have been supporting an "inflation targeting policy." However the continuous decline in prices in Japan derives from the fact that price level in Japan is the highest in the world. After such continuous price decline, it is surprising to see Japan's price level is still the highest in the world. According to the "Comparative Price Levels" report published by the Organization for Economic Cooperation and Development (OECD) in July 2002, Japan's price level was 39% higher than that of the United States, and 51%, 29%, 33%, 45% and 26% higher than Canada, France, Germany, Italy and the United Kingdom respectively. Since global markets are now integrated, there is a strong tendency for the price levels of different countries to converge. What is noteworthy here is that in such a conversion higher price levels converge into lower price levels. Otherwise the country or product concerned would lose its international competitiveness. That is why the Japanese price index keeps falling. Trying to introduce an inflation targeting policy is rather like trying to resist a water flow from top to bottom. The fundamental issue here is the so-called high cost structure of the Japanese economy. Almost everything is expensive in Japan including not only wages but also the infrastructure costs such as transportation and electricity. Because of this high cost structure, many Japanese companies have shifted production to other countries, including China. Because of this high cost structure, foreign direct investment (FDI) also tends to avoid coming to Japan. Thus a country with the world's second largest gross domestic product (GDP) ranks only 22nd in receiving FDI. Less FDI means less employment brought about by FDI. FDI in Japan created only 1.4% of total employment as compared to around 5% in the United States and Germany. It is imperative for Japan to rectify its high cost structure as soon as possible. In this regard the inflation targeting policy runs counter to the objective of Japan's economic policy.

There is an opinion that the different price levels of various countries should be adjusted through exchange rates. According to this opinion, the high prices of Japanese products or services should be rectified by weakening the value of the yen. This opinion is not realistic. First of all such a lowering of the yen rate has not happened thus far in the market. Secondly it is impossible for the Japanese government to intervene in the market to lower the yen although once in a while it does so to avoid rampant fluctuations. Japanese people possess ¥1,400 trillion in financial assets, but inflation would reduce the purchasing power of these assets.

Nowadays companies around the world are busy restructuring their businesses. One of the important measures for restructuring is to lower the cost of procurement. In this regard those restructuring companies are responsible for falling prices in general because the price index is the result of the accumulation of individual transaction prices. Needless to say, companies cannot be buyers all the time. From time to time they have to be sellers as well. On that occasion those companies have to face strong pressure from the procurement side to lower the prices. This is exactly what those companies are doing when they procure. Therefore those companies have to lower their prices, which results in deflation.

Supporters of an inflation targeting policy are similar to drug addicts. They postpone addressing the real issue by avoiding pain.

Of course the nominal revenues of workers and companies decrease in a deflationary world. However, the cost of production and the cost of living also decrease when prices fall. Therefore real incomes do not decrease in proportion to the fall in prices. It is also true that tax revenue declines in the case of deflation. However the government should be able to reduce the budget accordingly if the prices concerned fall.

There are some professors who claim that, although it is true that nominal costs fall in deflation, wages are inflexible and do not decline. Therefore real wages will go up, increasing labor costs and making the management of companies very difficult. They assert that a inflation targeting policy is necessary. Those professors must have failed to monitor the wage statistics. According to the statistics, nominal wages in Japan started falling on a year-on-year basis from 1998 and have kept falling until now with the exception of 2000.

The supporters of inflation targeting also say that although every nominal cost might fall under deflation, the amount of debts will never decrease since the borrowing of money is settled in nominal terms. That is true except for the cases where deflation-indexed debt bonds are issued as is explained by Professor NOGUCHI Yukio in this issue.

Technological development will continue in the world, leading to cost reduction and falling prices everywhere. In addition, an inexpensive Chinese workforce will keep putting a strong downward pressure on the international prices of goods and services. We ought to be prepared for deflationary pressure. We should be prepared to live with modest deflation, at least in the near future.