Abenomics

Keith Rankin, 12 April 2013

Japan, in a big way, is looking to create inflation and stimulate business investment spending by aggressively increasing its money supply while holding interest rates at zero. The stimulus, dubbed "Abenomics", after Prime Minister Shinzo Abe, follows long periods of "quantitative easing" in the United States and the United Kingdom, and a more recent and muted version in the Eurozone.

Japan wants to create inflation so as to bring about negative "real interest rates". Interest rates are regarded as negative in reality if inflation in the coming years is expected to be higher than base interest rates. The Economist ("Six years of low interest rates in search of some growth": 6 April) reports that, outside Japan, real interest rates are already negative.

The policy is likely to achieve its goals if it is conducted more aggressively than in the developed countries Japan regards as trading rivals. This is because the extra yen are sold for financial assets in other countries, reducing Japan's exchange rate. A falling yen can create inflation in Japan, by raising the domestic prices of internationally traded goods.

The more interesting question is what would happen if Abenomics was applied on a global scale. Certainly, if you add the USA, the UK and the Eurozone to Japan, then this is a large part of the global economy. And most other countries have low interest rates by their historical standards.

It is a core tenet of classical economics – essentially the macroeconomics for which Margaret Thatcher was most famous – that inflation or deflation can be turned on or off like a tap. The monetary authorities, nowadays the Reserve Banks, were believed to have full control of the amount of money in circulation and therefore of the inflation rate.

At least in the medium term (that is, allowing for a bit of adjustment time; in particular, adjustment of expectations), the monetary authorities could create global inflation by increasing money in circulation by a percentage greater than the growth of the world economy. Further, it was believed that this relationship would hold, whether the economy had full employment or substantial unemployment.

These views about the simple global relationship between money and prices were particularly prevalent in both the 1920s and the 1980s. Thus policymakers in the Great Depression of the 1930s believed that easy money conditions would be sufficient to reverse the deflation (negative inflation) of that time, and the resulting rising prices would revive the global economy. 1980s' explanations of the Great Depression emphasised the political failure to create the required money.

As the Depression persisted, American economist Irving Fisher came up with his famous debt-deflation theory. In 1933 Fisher showed that if all sectors of the economy attempted to get rid of debt simultaneously, then significant deflation would arise. Further, the deflation would increase rather than decrease the level of indebtedness in the world economy. Such a nasty downwards spiral clearly resembled actual global events in 1930 to 1932.

Fisher naively believed that a massive commitment by the monetary authorities to "print" money would offset the big falls in money that were taking place, and that deflation would give way to inflation. Indeed, historically, inflation has been the only peaceful resolution of global debt.

It was JM Keynes in 1936 who showed that simply creating more money was not sufficient to revive economies. There the matter of "liquidity preference". There had to be parties willing to spend the money; and, in the context of the mid-1930s, to spend it on a massive scale.

Those who could spend wouldn't, and those who would spend couldn't. Abenomics on a global scale would likely create a Keynesian liquidity trap.

Keynes favoured investment spending. And if businesses wouldn't invest in buildings and machinery, then governments would have to invest in infrastructure and new housing. Governments would borrow and spend the new money, creating huge amounts of taxable private income in the process. (Governments, if they spent enough to revive private incomes and spending, would need to run surpluses at other times, when private businesses in particular were running deficits.)

The world economy in 2013 is not the same as it was in 1932. The banks – at least, in Latin America, Africa and Oceania are borrowing the newly created money – creating large current account deficits in these parts of the world. Further, there are signs that Chinese consumers are spending more.

If the requisite inflation does happen in Japan, USA and Europe, it will be because their exchange rates are going down while others (such as ours in New Zealand) are going up. Massive amounts of cheap money, on their own, cannot revive those economies. Debt-enabled private spending in Brazil, Africa and Australasia can, however, along with belated spending of accumulated corporate cash in the USA and of household savings in China.

Shinzo Abe's monetary stimulus will revive Japan and contribute to global growth, so long as someone, not necessarily Japanese, spends the money.

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