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Learning To Love Inflation: The Japanese Experiment

Summary

- Far from shying away from it, Japan's policymakers are trying to encourage a sustainable version of inflation.
- With a structural shortage of labour and the offshoring of businesses no longer looking so attractive, the prospect of inflation remaining in the system appears high.
- Relative to most major economies, Japan will experience low inflation, but its arrival could be surprisingly positive.

While many countries are fighting inflationary pressures, Japan's policymakers are attempting to raise them on a sustainable basis. There are signs they are succeeding.

According to Mark Twain, history may not repeat itself, but it does rhyme. That appears to be the case for economic history too. In the 1970s and 1980s, the UK had the worst inflation problem of all the large developed countries whereas Japan was the fastest to tame the threat of rampant consumer prices.

Forty years on, the two countries remain at opposite extremes of the inflation experience, the UK with core inflation of 8.6% and Japan at 2.5% on the US definition. Why should that be? The answer is that inflation is not a purely economic phenomenon but relates to the deep structure of society and politics, which changes only very gradually, if at all. In the words of British sociologist John Goldthorpe, as quoted by investment scholar Edward Chancellor, "inflation is the monetary expression of distributional conflict", meaning that it is driven by social divisions.

In that case, you would expect countries with a high degree of political consensus to have low inflation – and that is indeed what we see in Japan and Switzerland.

From the mid-1980s to 2020, the global economy encountered a long wave of disinflation caused by globalisation, particularly the vast new supply of labour in China, the internet and the tough policies of inflation-fighting central banks.

This was excellent news for inflation-prone countries like the UK, but had the effect of driving Japan, which had conquered inflation long before, into outright deflation of a mild but chronic sort. The necessity of maintaining a massively overvalued currency to please the U.S. all through the two "lost decades" compounded its economic woes.

Now, the tectonic plates of the global economy are shifting again. A new inflationary wave has arrived. Money-printing by central banks during the Covid pandemic was the trigger, but the geopolitical distancing from China, the huge cost of the green transition and the reluctance of politicians to countenance a deep recession form the background. If such factors lead to inflation becoming entrenched, as the "distributional conflict" theory suggests it might, the tables could be turned in a spectacular way. Deflation-prone Japan could be a major beneficiary while the inflation-prone countries struggle to grow.

Under Japan's long-lasting deflationary regime, households kept most of their huge stash of financial assets in cash. This was not some strange cultural proclivity but mere common sense in a world in which prices, wages, land and stock prices were more likely to fall than rise. A zero return was better than a capital loss. Likewise, Japanese corporates, many of which had taken on huge debt loads during the 1980s bubble economy, went through decades of deleveraging. The result: their balance sheets are super-solid but "inefficient" by non-deflationary standards, as many activist investors – foreign and Japanese – have noticed to their benefit.

If the inflationary turn is real, Japanese financial behaviour will change significantly and much else besides. Inflation benefits job-hopping younger workers and disadvantages cash-rich retirees. It has a psychological element too. "Money illusion" can make people feel they are getting richer when they are not, leading to an optimistic mindset. Deflation, by contrast, offers no such consolations. It is no surprise that Japan's suicide rate soared in "the lost decades" but has recently declined to historically low levels.

Mild, domestically-driven inflation is far from disastrous. Indeed, Japan's "economic miracle" of the 1960s was accompanied by inflation that averaged 5.5% between 1960 and 1972. France's "thirty glorious years" from 1945 were similar. Of course, today's Japan is a much older, slower country than it was in the 1960s, but it doesn't follow that its fate is necessarily deflationary. Indeed, in their book "The Great Demographic Reversal", Professor Charles Goodhart and Manoj Pradhan forecast that global demographic headwinds will lead to higher inflation and interest rates across the developed world.

Why hasn't that happened in Japan thus far? First, because between 2012 and 2020, the Japanese labour force expanded by 8% as previously non-working elderly people and women took jobs. Second, because Japanese companies moved a large amount of production offshore. Third, because of the steady decline in hours worked, suggesting that increased leisure substituted for higher pay.

Things are likely to be very different looking forward. The supply of potential new entrants to the labour market from domestic sources is tapped out. With the yen near 50-year lows on an inflation-adjusted basis and concerns about overseas supply chains, offshoring is no longer attractive and might even reverse in some cases.

The overwhelming likelihood is that Japan is facing a structural labour shortage, with dramatic consequences. The capital investment share of GDP is likely to rise to a new plateau as companies substitute machines for increasingly expensive people. Given that opinion surveys from Pew Research and the Nikkei show a large majority of the public accepting the case, higher immigration is a certainty.

The "hataraki kaikaku" – reform of working practices – will take off with or without government prompting. More and more women will occupy important jobs, not for reasons of gender equality but because it makes commercial sense. With its male bonding rituals centred on alcohol and late night carousing, the "salaryman" culture is already winding down. Japan has fully recovered from the pandemic but footfall in entertainment districts like Roppongi and Shinjuku has not.

Goodhart and Pradhan suggest that a global labour shortage would lead to a rise in the labour share of income and a decline in the profit share, leading to a reduction in inequality. Income and asset inequality is not a big problem in Japan, but there is a strong probability of a squeeze on all-economy profits, especially in labour intensive industries, leading to consolidation of many sectors with too many marginal competitors.

None of this is going to happen quickly. What we are seeing are promising signs. In the last GDP release, the deflator rose 2% on the previous year, contributing to a nominal GDP print of 3.9%, one of the strongest performances in decades. Since Kazuo Ueda took over as Governor of the Bank of Japan, the market's expectations of inflation, as measured by the difference between inflation-protected bonds and regular bonds, have soared. Furthermore, inflation in services and other domestic areas is gaining traction while the externally-derived inflation drivers – higher energy and food prices - are fading.

In all likelihood, Japan will continue to experience low inflation compared to other developed countries. But if wages, rents and dividends play a full part, the overall effect could be surprisingly positive.