

## The Incurable Japanese Syndrome And Europe



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For the fifth time in seven years Japan is back in recession, with GDP shrinking by a further 0.2% in the third quarter. Meanwhile, inflation has fallen from more than 2% to zero in just over six months. This is certainly not the first time that Japan has 'gained' a recession/deflation status: the growth dynamic of the Japanese economy has been blocked for over 20 years since the burst of the most extreme real estate bubble of the 20th century.

The distinctive feature of the current situation (and also the most worrying for us Europeans) is that Japanese Quantitative Easing is currently fully operational. The Bank of Japan (BOJ) has been buying government bonds on the markets since 2013 and doubled

the programme in October 2014: up to €600bn a year have been injected into the economy, also through purchases of mutual funds and shares. It is estimated that the BOJ currently owns 35% of all sovereign bonds in circulation and is buying 100% of recently issued government securities. Apparently, a government deficit hovering around 8% of GDP in the last seven years is not sufficient to meet the BOJ needs of fresh bonds to buy. What is sure is that the strong fiscal expansion plus deflation has inflated public debt to the astronomical level of 230% of GDP from 60% in the early 90s.

In 2013, the BOJ, prompted by the new prime minister Shinzo Abe, tried out a flexible – and unprecedented – monetary expansion to pull Japan out of the deflation mire. Although the initial results were encouraging (inflation increasing by 3% and growth by 1.1% for the first quarter of 2014), the stimulus quickly wore off and overall numbers now are worse than those observed in 2013. Moreover, it is unlikely that in these conditions the BOJ could further increase the programme, since it may not find sellers on the market (even the government!) that can meet the demand for securities: QE is literally running out of resources.

Where does the debacle of Japanese QE come from? Economists tell us that there are three ways in which QE transmits benefits to the real economy: a reduction in interest rates that banks apply to companies and consumers, a devaluation of the nominal exchange rate and a permanent increase in inflation expectations. What actually happened?

As in Europe, the banks have preferred to invest in financial markets rather than in the real economy. With regard to loans to enterprises, the results have been disappointing in Japan as in Europe: the increase was only 2% per year, absolutely insufficient to support the revitalization of the massive industry complex. Meanwhile, the stock market bubble has been inflated with the Nikkei index increasing 110% in little more than two years, completely disconnected from economic fundamentals.

However, how can one blame the banks for investing in shares, if the BOJ is substantially ensuring that – in any case – it will intervene to support stock indices? It's like a bet that cannot be lost: in technical jargon, the BOJ is implicitly selling a put option on the Nikkei index to market participants.

However, the yen did depreciate against the dollar and the euro with the predictable consequence of helping Japanese exports to recover from the heavy damage inflicted by competition from China and South Korea.

The profits of big corporations increased, but have not been reinvested in the economy; companies have preferred to increase dividends, to speculate in the financial markets or even to buy back their own shares rather than expanding their manufacturing base.

It is certainly not a sign of trust in a country's future if its historical corporations give up on investing in future growth themselves. But this is something that highlights the structural problems of the Japanese economy, beyond what can be done with monetary policy alone.

Briefly, Japan does not grow because it cannot grow; with a declining and rapidly ageing population, the future potential of the economy is low. The elderly tend to consume less and save more and the labour market has difficulty in finding specialized profiles; in this environment the return of the investment in real assets is meagre at best. The result is that there are no real incentives for the growth of public and private investment: even the most classical public interventions aimed at expanding infrastructure and public services has a negative net return, since the country is massively overbuilt and clogged by a general overcapacity in the manufacturing sector. For these reasons, inflation cannot take hold and indeed the expectations of deflation are reinforcing.

Japan shares many of these characteristics with Old Europe (that is plagued moreover by the dysfunctions of its monetary union), but there is a fundamental difference: the phenomenon of immigration in Japan is almost unknown, with a population that is fully homogeneous. After the gunboats of **Commodore Perry**, Japan opened up to the world but never entirely, missing the opportunities (and certainly also avoiding the problems) of a multicultural society. Cultural homogeneity is a factor of cohesion and solidity that favours the intergenerational redistribution of wealth between the elderly and younger people: this is the main economic reason enabling Japan to manage those incredible levels of long-term public debt. Nevertheless, as the demographics is slowly changing, the other side of the coin is emerging: uniformity could prove a decisive brake on the country's growth prospects.

In Europe the frantic efforts to control migrant flows are putting enormous strain on governments and people in countries such as Italy and Greece. Nevertheless, the Japanese trap suggests that homogeneous societies also suffer from chronic imbalances; refusing to accept the challenges of migration that are shaping our future is not a viable response for Europe.