Inflation and Fiscal Balance

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Global Inflation and Inflation in Japan

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The current global inflation apparently has aspects of both "cost-push inflation," which is attributable to supply-side factors such as the worldwide supply chain disruptions due to the COVID-19 crisis and constraints on resources and energy due to the Ukraine situation, and an "inflation spiral," in which a wage upsurge caused by a labor shortage and general price increases mutually amplify each other. If such a self-perpetuating inflation spiral accelerates, eventually, the kind of hyperinflation that frequently strikes developing countries could be triggered due to the loss of public confidence in currencies. Therefore, governments around the world are trying to hold down the ongoing inflation by slowing down economic activity through rapid monetary tightening.

The situation in Japan is not an inflation spiral but the economy is in a cost-push inflation phase in which inflationary pressures are gaining additional momentum from the yen's depreciation due to the widening of the interest rate differential vis-a-vis the United States and Europe.

Prospects for Inflation and Fiscal Balance in Japan

In Japan, the cost-push inflation has had a direct impact on such industries as food and energy as well as low-income families, whereas a demand shortage continues at the macroeconomic level. Therefore, it would not be appropriate at this moment to cool down demand through monetary tightening. The necessary course of action is to mitigate the adverse effects of the cost increase through subsidies for specific industries and redistribution for low-income families. In short, the government should implement targeted fiscal measures, and in that case, a temporary deterioration of the fiscal balance may be inevitable.

However, as will be explained below, inflation may work to improve the fiscal balance if it remains mild.

First, the experience of prolonged inflation—even cost-push inflation—will likely feed inflation expectations.

One reason why Japan has remained in a deflationary mindset is this: while there have not been calls for wage hikes because higher wages were not a priority for households amid stagnant prices, the lack of wage growth has reduced households' inflation tolerance, making it difficult for companies to raise prices. Presumably, the lack of wage growth and stagnant prices have created a mutually reinforced vicious cycle of cause and effect. Shock therapy in the form of mild inflation would stop this cycle.

If that happens, a mild inflation spiral may arise due to moderate wage growth, with price increases and wage growth mutually amplifying each other. That would bring higher tax revenue, and the fiscal balance could improve as a result (unless interest rates rise in the meantime).

However, if the inflation spiral surpasses a mild price growth of around 2% and accelerates further, Japan will face the same situation as the one now being experienced by the United States and Europe. In that case, Japan will have to hold down the inflation through monetary tightening, just as the United States and Europe are doing.

Moreover, it should be kept in mind that even if the inflation rate and the wage growth rate are stabilized at around 2%, the government's economic management will have to take into consideration future interest rate hikes. If the economy is put on a balanced growth path (BGP) and continues to grow in a stable manner, theoretically, real interest rates on safe assets should become positive barring significant market distortions. Therefore, real interest rates in Japan are also likely to converge toward positive values. If that happens, in the long term, nominal interest rates in Japan are expected to exceed the inflation rate (=2%) given the following equation: nominal interest rates ≒ real interest rates + inflation rate. While an interest rate hike is not immediately necessary, the ideal balanced growth path for Japan is a situation where the inflation rate consistently remains at around 2% and interest rates stay stable above 2%. Therefore, under that premise, a long-term path of monetary policy (exit strategy) must be established.

Maintaining Confidence in Fiscal Balance

Although raising nominal interest rates may appear to undermine fiscal sustainability, what determines the long-term fiscal sustainability is the level of the real government bond yield (r) relative to the level of the real economic growth rate (g), rather than the level of the nominal interest rate or the inflation rate.

For the past 10 years or so, r has remained lower than g ($r<g$). There is an argument that if this relationship of inequality continues, the government's debt ratio will remain under control even without the primary balance turning to surplus, with the result that fiscal consolidation efforts become unnecessary. However, when an economy without market distortions is on a balanced growth path, in theory, the

relationship of inequality where r>g applies. Therefore, Japan should aim to raise the level of r above that of g in the long term, and in order to maintain fiscal sustainability, it is essential to turn the primary balance to surplus in the long run.

Even so, if the inflation becomes entrenched, it will eventually induce a rise in nominal interest rates in the long term, raising concerns over fiscal sustainability. The government should make clear the goal of creating an economic situation of r>g in the medium to long term and maintain public confidence in fiscal consolidation. For example, it may be necessary to institutionally ensure that confidence in fiscal sustainability is maintained, by establishing an independent fiscal organization responsible for mapping out a long-term path to fiscal consolidation.

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