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Japan Can't Revitalize Economy with Monetary Easing Alone

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As political parties have been releasing their campaign promises toward the December 16 general election, the Liberal Democratic Party's monetary easing policy has attracted attention since LDP President Shinzo Abe's call for unlimited easing. In order to overcome deflation, however, Japan should implement structural, regulatory and tax reforms to allow abundant money flooding the banking system amid monetary easing to flow into the real economy.

Limited effects of quantitative easing

Pro-reflation people, or those in favor of triggering inflation through policy measures, have claimed that Japan's quantitative easing has had no inflationary effects because of its limited scale and called for a larger-scale monetary relaxation as seen in the United States.

The U.S. Federal Reserve implemented two quantitative easing programs by last year and launched the third one, or QE3, on September 13. After the QE1 program started in November 2008, the unemployment rate remained above 9%, with employment failing to expand despite an earnings recovery for banks. Even the QE2 program from November 2010 did nothing more than lower the unemployment rate from 9.8% to 8.8% in March 2011. Although money supply growth through quantitative easing had been expected to bring about such real economic effects as jobless rate improvements, business investment growth, faster economic growth and an end to housing price drops, no such effects have been identified.

The QE3 cannot be expected to boost stock prices more than the QE1 or QE2. Given that the dollar cannot be expected to accelerate its decline against other currencies under the U.S. government's planned austere budget policy for fiscal 2013 and other major central banks' ongoing quantitative easing, we cannot expect monetary easing to have spillover effects on the real economy through bond, credit, foreign exchange and stock markets. In general, quantitative easing, though prompting an economic recovery to some extent, may fall short of stimulating investment or improving the unemployment rate.

More important are structural and regulatory reforms

The Bank of Japan has already been implementing unlimited monetary easing. The BOJ's gross assets as a percentage of gross domestic products expanded from 27% to 33% in about two years from 2011, while the Fed's gross assets rose from 17% to only 19%. But the current yen-dollar exchange rate is almost the same level as it was early 2011, and no remarkable fall in the yen has been seen. Monetary easing represents the transformation of government bonds into money (issuing money for purchases of government bonds) and expands the BOJ's government bond holdings to run counter to budget discipline and consolidation.

Even if the central bank purchases government bonds endlessly with nominal interest rates remaining at zero, money provided through the purchases may remain in the banking system without flowing into the real economy. The most important point is whether there is any demand for money. Japanese companies as a whole still have surplus money and have refrained from raising money from the outside. As money demand is limited in the absence of economic recovery projections, many companies do not go so far as to borrow money for capital investment.

Fiscal and monetary policies essentially represent stopgap measures to delay fundamental solutions to problems. Japan must create money demand in order to revitalize its economy. To this end, it must fundamentally restructure its economy.

"Constant regulatory reforms" as one of the LDP's campaign promises should not end as an empty slogan. If the LDP hesitates to take part in the proposed Trans-Pacific Partnership free trade agreement, it may fail to implement the regulatory reform promise. Rather than monetary easing or fiscal measures, reforming institutions and regulations that deviate from international standards must be the pillar of Japan's economic revitalization strategy.

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