PANDEMIC RECESSION AND THE PRACTICE OF MODERN MONETARY THEORY IN JAPAN

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EAI Background Brief No. 1563

Date of Publication: 22 October 2020

Executive Summary

1. For more than two decades, Japan has been struggling with deflation. Modern monetary theory (MMT) provides an alternative policy option for the Japanese government to boost inflation and support economy growth. The recession triggered by the COVID-19 has further enhanced the importance of MMT, despite criticisms by mainstream economists.

2. The Abe administration declared a state of emergency in April and May 2020, which froze most non-essential economic activities, causing the economy to suffer a sharp fall in consumption, investment and exports, and slipping into a pandemic recession.

3. In the quarter of April-June 2020, Japanese gross domestic product (GDP shrank 7.8% from the preceding quarter, or at an annualised pace of 27.8%.

4. In response to the economic impact of the coronavirus pandemic, the Abe administration rolled out a 117 trillion Japanese yen stimulus package. The size of the package is about 21% of Japanese GDP, one of the largest among OECD countries.

5. To date, Japanese public debt to GDP ratio has exceeded 230%. Issuing more government bonds for delivering the stimulus package would further worsen the sustainability of Japanese public debt. However, the support for the massive coronavirus stimulus—and its success in forestalling the worst possible outcome of broad shutdowns—is rooted in the MMT.

6. On 27 April 2020, the Bank of Japan (BOJ) announced that it would purchase a necessary amount of Japanese government bonds without setting an upper limit. BOJ's decision apparently makes itself the fiscal agent of or the banker to the government, consistent with the interpretation of MMT on the role of central banks.

7. The increase in the assets of the BOJ indicates that the central bank has been very aggressive in injecting liquidity into the economy. The assets of the BOJ jumped to 665.9 trillion yen by July, 37% higher than Japanese real GDP!

8. To actively purchase exchange traded funds (ETF) in stock markets is another means of injecting money into the economy. After the Nikkei 225 index started to fall from its peak of 24,000 because of the pandemic, the BOJ substantially stepped up purchases sharply. It doubled its annual target for ETF purchases to 12 trillion yen to combat the effects of the coronavirus.

9. Even the sudden resignation of Japanese Prime Minister Abe and the change of leadership in Japan are unlikely to alter the future monetary policy of Japan. The newly elected Prime Minister Yoshihida Suga said: “I want to continue Abenomics and enhance it”.

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Modern Monetary Theory: An Option for Japan?

1.1 Japan has been struggling with deflation for more than two decades, the fundamental root of which is the persistent lag in aggregate demand versus aggregate supply. Given more than 230% of the debt to GDP (gross domestic product) ratio, standard economic theories offer few policy choices for the Japanese government to boost inflation and support economy growth. Modern monetary theory (MMT), an unconventional economic theory promoted by a group of non-mainstream economists, provides an alternative policy option for the Japanese government.

1.2 MMT argues that a sovereign government should not be concerned with fiscal deficit, and fiscal expansion supported by the central bank's open market operations is the right choice to raise aggregate demand and achieve full employment. The outbreak of the COVID-19 pandemic however has disrupted normal economic activities globally, resulting in the dramatic contraction of aggregate demand in not only Japan, but also the rest of the world. Japan has fallen into a pandemic recession along with other countries hit by the pandemic. This development has elevated the importance of MMT further, despite criticisms of mainstream economists.

1.3 Since December 2019, the world has been mired by the COVID-19 pandemic. The fast spread of the coronavirus, from the epidemic centre Wuhan, China to the rest of the world, has transformed the epidemic disease into a pandemic one, instilled fear and anxiety in societies and seriously disrupted normal routines.

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1.4 By the end of September 2020, more than 30 million people had been infected by the COVID-19 virus, with a death toll of more than one million. It remains uncertain when the pandemic would be over and effective vaccines would be ready.

1.5 Factories shutting down, national borders closing, social distancing, executing voluntary or involuntary quarantines and other measures to prevent the further spread of COVID-19 have crippled vibrant human activities and dragged the global economy into an unprecedented pandemic recession. The International Monetary Fund (IMF) projected that the world economy would shrink 4.9% in 2020.[1]

1.6 Compared with most industrialised countries, Japan has weathered the pandemic relatively well. Japan is a country with one of the highest population density in the world. Using public transportation for commuting is part of daily routine for millions of Japanese salary men. Thanks to the habit of wearing masks for preventing flus and the maintaining of high hygiene standards, by September 2020, Japan registered about 82,600 infected cases and 1,570 casualties.

1.7 In April and May, the Abe administration declared a state of emergency, which empowered local governments to urge people to close their business and stay at home, without imposing punitive measures or legal actions against people who did not follow the advisories. The state of emergency simply froze most non-essential economic activities, causing the economy to suffer a sharp fall in consumption, investment and exports and slipping into a pandemic recession.

Stylised Facts on the Pandemic Recession in Japan

2.1 According to the Japanese government, in the quarter of April-June 2020, Japanese GDP shrank 7.8% from the preceding quarter, or at an annualised pace of 27.8%, as private consumption and exports bore the brunt of the coronavirus pandemic. It is the third consecutive decline on the quarter and the biggest fall in Japanese quarterly GDP since 1955, exceeding the 4.8% drop in January-March 2009 in the wake of the Lehman crisis.

1 International Monetary Fund (2020). “World economic outlook update, June 2020”, June 2020.

2.2 The April-June 2020 plunge wiped out most of the growth achieved under Abenomics,[2] the signature economic programme of Prime Minister Shinzo Abe in his eight years of leadership. At the micro level, many Japanese companies are facing slumping demand. Japan's listed companies have been shoring up for their worst downturn since the global financial crisis, with an expected shrink in aggregate net profit by 36% for the current fiscal year.

2.3 Toyota Motor forecasts a 20% drop in sales and a 64% plunge in profit. The automaker is bracing for a 13% contraction in global unit sales. Isetan Mitsukoshi Holdings, a leading luxury Japanese department store, expects an annual loss of 60 billion yen and is beginning to close stores this year.[3]

2.4 The greatest loss could come from the much-hyped 2020 Tokyo Olympics. Japanese society and the Abe administration had spent billions of yen preparing for the the opening ceremony of the 2020 Tokyo Olympics. They expected the 2020 Tokyo Olympics to be a window to show the world a complete new Japan after the "lost two decades". It took Japan six years and at least $12 billion to build the new stadium, train stations, airport terminals and condominiums for the expected game.

2.5 Corporate Japan had backed the Olympics to an unprecedented degree. In total, 62 Japanese companies signed up as local sponsors for the games, pledging a total of more than $3 billion – nearly three times the previous Japanese record – to the Tokyo 2020 organising committee in exchange for six years of marketing rights.

2.6 However, the pandemic has not only shattered the dream of Japanese people, but also left a huge financial burden for Japan. The delay of the 2020 Tokyo Olympics is said to cost Japan $6 billion in economic losses.[4]

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2 Abenomics refers to the economic policies of monetary easing, fiscal expansion and structure reforms implemented by the Abe administration.

3 Minamihata, R and Murakami, T (2020). "Japan Inc. profit set to sink 36% this year, but rebound on way", *Nikkei Asian Review*, 11 August 2020.

4 Imahashi, R and Regalado, F (2020), "Olympics delay to cost Japan $6bn in economic losses", *Nikkei Asian Review*, 24 March 2020.

2.7 Tourism had been one of the most shining achievements of the Abenomics and a pillar for the future growth of Japanese economy. In 2019, the number of foreign visitors to Japan surpassed the 30 million mark, more than triple the number in 2012 when Abe won the election.

2.8 Since April 2020, to contain the spread of the COVID-19 virus, Japan has banned visitors from almost 150 countries. The restriction effectively stopped the inflow of foreign visitors to Japan, dragging tourist arrivals to 0.1% of pre-coronavirus levels. On average just 85 visitors a day came to the country from overseas, down from 87,000 a day in January, incurring dramatic economic losses to hotels, restaurants, department stores and airlines.[5]

The Largest Stimulus Package

3.1 In response to the economic impact of the coronavirus pandemic, the Abe administration rolled out a 117 trillion Japanese yen stimulus package. The size of the package is about 21% of Japanese GDP, one of the largest among OECD countries and much larger than the fiscal stimulus implemented for coping with the global financial crisis in 2008.

3.2 Specifically, the package includes a variety of cash payment programmes for individuals and households. The most outstanding one is the unconditional cash payment of 100,000 yen to each of some 126 million people in Japan, including foreigners living in Japan with long-term visas.[6]

3.3 There is a special cash handout programme for university students who lost part-time jobs. The programme offers 200,000 yen of financial support to each of those students. For the unemployed, the government provides three to nine months of rent subsidy; for people with financial difficulty, they can apply for emergency loans of up to 800,000 yen for a family and 650,000 yen for an unmarried person.

5 *Kyodo News* (2020), "Foreign visitors to Japan drop 99.9% in June for 3rd straight month", 15 July 2020.

6 *Kyodo News* (2020). "Japan gov't submits extra budget for virus rescue package", 27 April 2020.

3.4 The stimulus package also consists of many direct cash transfer programmes supporting small and medium-sized enterprises (SME). SMEs that suffered more than 50% fall of revenues could receive up to two million yen subsidy. Self-employed persons could receive up to one million yen of financial aid.

3.5 Rental and wage subsidies are also budgeted in the stimulus package. SMEs can apply for up to six million yen rental subsidy and the self-employed can receive rental subsidies of up to three million yen.

3.6 SMEs that were forced to close during the state emergency are qualified for wage subsidies. For small companies—those in the service sectors with workers up to five and manufacturers up to 20—the government subsidised 100% of their employees' salaries. The programme is estimated to cover three million companies and more than 10 million employees.

3.7 Japanese consumers and workers have been spooked by the high infection rate and fast spread of the coronavirus. Shopping, dining out, travelling and commuting activities have fallen off the cliff, a disaster for the Japanese service and tourism industry. To boost domestic tourism industry, the stimulus package allocates 1.7 trillion yen to promoting "Go To campaign" which kicked off in late July. For all registered hotels, inns and airlines, the government subsidises half of domestic travel costs of up to 20,000 yen per night per person and issue coupons that can be used at souvenir shops, restaurants and other outlets.[7]

3.8 For building resilient supply chains and reducing excess dependence on China, the stimulus package earmarks 245.6 billion yen to help Japanese firms move their supply chains out of China to Southeast Asia or back home. Japanese Ministry of Economy, Trade and Industry disclosed that 87 companies received 70 billion yen of subsidies for shifting their supply chains out of China by July.[8]

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7 *Japan Times* (2020), "Japan will aim to shore up travel demand from late July", 25 May 2020.

8 Nikkei (2020), "Japan reveals 87 projects eligible for China exit subsidies", *Nikkei Asian Review*, 17 July 2020.

Modern Monetary Theory: The Theoretical Foundation of the Stimulus Package

4.1 The 117 trillion yen stimulus package comprises many direct cash transfer programmes to individuals, households and SMEs, much like the "helicopter money" that was freely distributed to the Japanese people and companies. Without any doubt, recipients were happy to receive the free-lunch like cash payments, in particular at a difficult time of the coronavirus. The ultimate question that arises out of these public policy proposals is how all these will be paid for.

4.2 To date, Japan has the highest debt among all OECD countries. Its public debt to GDP ratio has exceeded 230%, much higher than that of the United States and even higher than the level that triggered the sovereign debt crisis of Greece. Clearly, without issuing more government bonds, it would be impossible for the Japanese government to deliver all the promises outlined in the stimulus package.

4.3 According to mainstream economic theory, framed by the classic IS-LM model,[9] further debt accumulation would trigger inflation, yen depreciation and the collapse of the Japanese bond market. Simply put, the stimulus package may push Japan into an economic disaster in the long run.

4.4 However, the support for the massive coronavirus stimulus—and its success in forestalling the worst possible outcome of broad shutdowns is rooted in the MMT, once an obscure branch of economic thinking that has been gaining mainstream attention after the global financial crisis.

4.5 MMT bases its theory on the fact that the Japanese government is a currency issuer. It has its own sovereign currency: the yen. As the government is the exclusive supplier of the yen, it can print as much as it needs without the worry of insolvency.

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[9] IS-LM model refers to a dominant macroeconomic model where goods, money and foreign exchange markets interact with each other.

4.6 From the perspective of MMT, fiscal deficit is mirrored by the saving of the private sector while fiscal surplus implies an equivalent amount of private debt. Pursuing balanced budget is not necessary, even at full employment. Fiscal deficits do not automatically push up interest rates, but raise people's income and are much better than bank loans.

4.7 MMT provides a theoretical foundation for the so-called "helicopter money" proposed by former Fed chairman Bernanke as the last resort of central bank to fight deflation and boost economic growth. It primarily considers fiscal policy as more effective than monetary policy and advocates aggressive fiscal expansion to achieve full employment.

4.8 When an economy faces a pandemic recession, there is a sharp fall in aggregate demand and not enough inflation. MMT can be very helpful because it casts a more optimistic and less constraining light on the ability of governments to stimulate aggregate demand and prevent inflation.

4.9 Even though Japanese government officials often denied that Japan has been practising MMT, it is often cited as a convincing example why mainstream macroeconomics is wrong while MMT is the right policy recipe for maintaining economic prosperity without concerns of inflation. Dispensing with the fear of debt sustainability in the long-term, the Abe administration rolled out the unprecedented stimulus package, that is equivalent to one fifth of the Japanese GDP and largely depending on newly issued debt. This implies that the Japanese government has been following the policy prescription of MMT even though it had openly rejected MMT policies repeatedly.

4.10 The intention of the Abe administration notwithstanding, monetising public debt has been an evolving phenomenon in Japan. By the end of January 2013, the Bank of Japan held 89.2 trillion yen in Japanese government bonds. The figure surged to 406.7 trillion yen at the end of January 2019, constituting about half of the total outstanding Japanese government bonds and making the central bank the largest creditor of the Japanese government.

4.11 Even through Japanese households, commercial banks and companies hold the rest of Japanese government bonds, the credit and debt circulation now mainly runs between the central bank and the government. The actions of the central bank, and not those of private investors, will determine the fate of Japanese public debts.

Bank of Japan: Ready to Purchase Unlimited Government Bonds

5.1 Smooth coordination from central banks is essential to implement MMT policies. To support the government's efforts for rescusing the economy from the effects of the coronavirus, the Bank of Japan announced that it would purchase a necessary amount of Japanese government bonds without setting an upper limit on 27 April 2020 after the one-day special policy meeting.

5.2 The decision abolished the 80 trillion yen yearly cap on its government bond purchase introduced in October 2014 for reviving the sluggish Japanese economy and achieving the two per cent inflation target. The central bank's decision apparently makes itself the fiscal agent of or the banker to the government, consistent with the interpretation of MMT on the role of central banks.

5.3 Additionally, it greatly expands the spending capacity of the government beyond the constraint of tax revenues, implying that neither taxes nor fiscal deficit would impose a monetary budget constraint on the government. This is consistent with MMT, which states that taxes are not the sources of government expenditure but a policy instrument of controlling inflation.

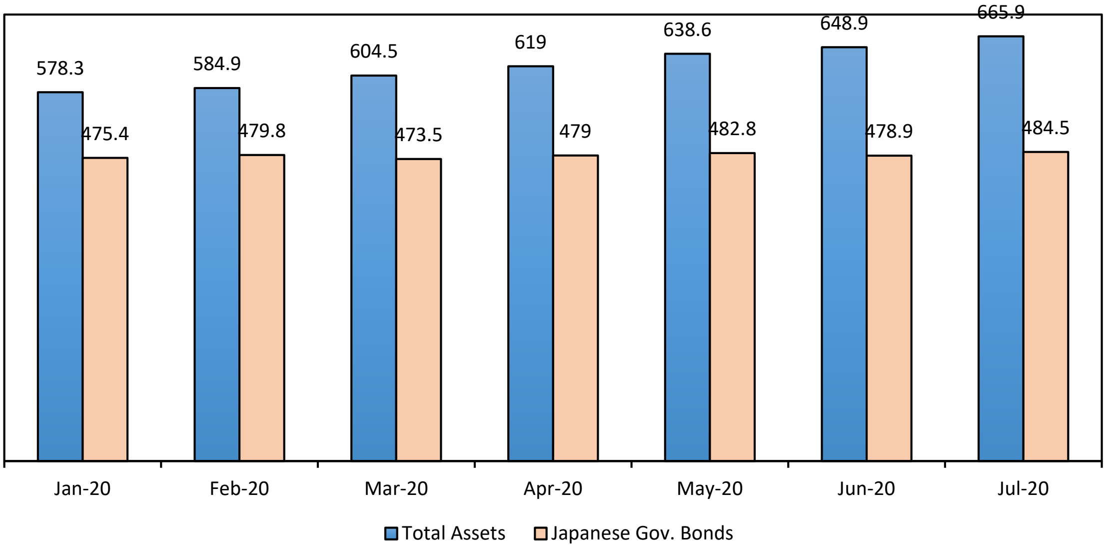
5.4 One of the core arguments of MMT is that a monetary sovereign government has unlimited financial capacity to purchase whatever it wishes and fulfil its future financial obligations. The ability to purchase unlimited government bonds at least theoretically grants the Japanese government with unlimited financial power.

5.5 According to Governor Kuroda,[10] the Bank of Japan has accelerated monetary easing since March 2020. It started a special programme to support financing mainly of firms. The total size of this programme is about 110 trillion yen, of which 20 trillion yen is allocated to purchase commercial papers and corporate bonds. The 20 trillion yen is equal to about a quarter of the Japanese market for commercial papers and corporate bonds.

5.6 The central bank also introduced funding measures of about 90 trillion yen to encourage lending by financial institutions. The fund is provided to financial institutions with zero interest rates. In turn, the central bank rewards financial institutions with 0.5% interest of the loans made to SMEs with the fund. For a market with zero or negative interest rate, the 0.5% interest rate is a very significant incentive for commercial banks to increase their lending.

5.7 The increase in the assets of the Bank of Japan indicates that the central bank has been very aggressive in injecting liquidity into the economy. The assets amounted to 578.3 trillion yen at the end of January. The figure jumped to 665.9 trillion yen by July, or more than 15% growth in six months (Figure 1).

FIGURE 1 ASSETS AND JGB HOLDINGS OF THE BANK OF JAPAN (TRILLION JAPANESE YEN)



Source: Japan Macro Advisors.

[10] Kuroda, H (2020), "The impact of COVID-19 on the Japanese economy and the Bank of Japan's response", remarks at the virtual event co-hosted by Harvard Law School and the programme on international financial system, 26 June 2020.

5.8 Of note is the fact that Japanese GDP actually fell 7.8% in the second quarter of 2020 and annualised real GDP was 487 trillion yen. The assets of the central bank proxies the quantity of base money. Compared with the real GDP, the base money in the circulation of the Japanese economy was 37% higher than real GDP! Japan may be the first industrialised nation whose monetary base significantly exceeds the size of its real economy.

5.9 In the first half of 2020, Japanese government bond holding of the central bank rose substantially. At the end of January, the central bank held 475.4 trillion yen in Japanese government bonds and by end July 2020, the figure increased to 484.5 trillion yen, suggesting that the central bank purchased an additional 10 trillion yen in Japanese government bonds. This is in line with the bank's policy to purchase unlimited amount of government bonds whenever it is necessary.

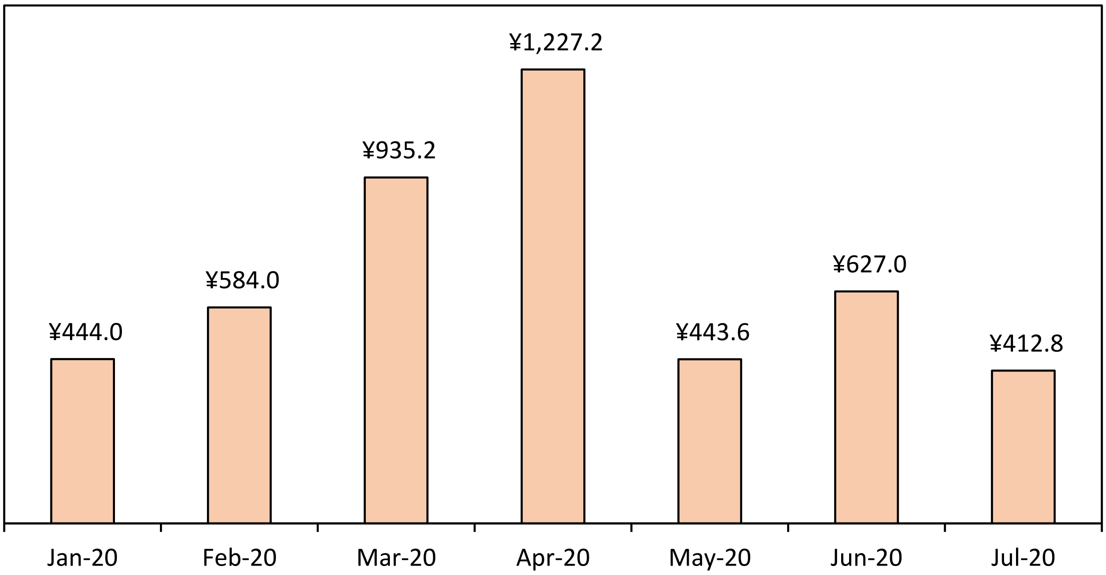
5.10 To actively purchase exchange traded funds (ETF) in stock markets is another means of injecting money into the economy. The aim is to prevent the deterioration in sentiments of firms and households when financial markets became volatile, thereby supporting positive economic activity. The Bank of Japan has turned into the largest holder of ETFs of Japanese stock markets.

5.11 In January 2020, the Bank of Japan purchased 444 billion yen of ETFs. After the Nikkei 225 index started to fall from its peak of 24,000 because of the pandemic, the Bank of Japan has substantially stepped up purchases sharply. It doubled its annual target for ETF purchases to 12 trillion yen to combat the effects of the coronavirus.

5.12 In March the Bank of Japan bought 935 billion yen in ETFs, more than double that in January as the Nikkei dipped to 16,500, more than 30% off the high in February 2020. In April, the monthly purchase surged to 1.23 trillion yen. In the period of January-July, the Bank of Japan bought 4.67 trillion yen in ETF (Figure 2).

5.13 While investors use their income or wealth to purchase stocks, central banks use the monopoly power of printing sovereign currencies to purchase stocks. This unique phenomenon is a practice of MMT.

FIGURE 2 ETFS PURCHASES BY THE BANK OF JAPAN (BILLION JAPANESE YEN)



Source: Bank of Japan.

Future Perspectives

6.1 The pandemic recession differs from any economic recessions in the modern history of the world economy. It is not a recession triggered by excessive public debts, housing bubbles, surging energy prices or wars. It is a recession sparked off by sudden, stalled economic activities, or a sharp fall in aggregate demand. Aggressive fiscal stimulus is the right policy response.

6.2 Japan is not alone in implementing aggressive fiscal policy. Most of the countries infected by the coronavirus launched huge fiscal stimuli. The US Congress approved a $2 trillion stimulus package, the largest in emergency relief bill in American history. According to the IMF, global public debt is expected to exceed 101% of the world GDP in 2020.

6.3 Combined with aggressive purchases of government bonds by central banks, the aggressive fiscal policy has generated the ongoing debate on the consequences of this fiscal expansion and outright debt monetisation by central banks. However, from the perspective of MMT, those concerns are not justified.

6.4 That aggregate demand is persistently lower than aggregate supply is one of the necessary conditions for implementing MMT style macroeconomic policies. To date, 27% of the Japanese population is 65 years old and above. The ratio is set to rise to 40% by 2060.

6.5 An ageing society has constantly diminished the aggregate demand of the Japanese economy, creating an environment suitable for implementing MMT policies. The pandemic has further suppressed Japanese domestic consumption and investment, making MMT policies urgent and necessary.

6.6 In the long-run, inflation remains a major concern of MMT style policies. However, raising taxes is a tool for controlling inflation according to MMT. The most recent data shows that Japanese consumer price index in June 2020 did not change compared with a year earlier. Governor Kuroda has repeatedly emphasised that the monetary easing will not stop before the 2% inflation target is achieved. This implies that Japanese monetary and fiscal policy will continue to move along the path defined by MMT for the foreseeable future.

6.7 Even the sudden resignation of Japanese Prime Minister Abe and the change of leadership in Japan are unlikely to alter the future monetary policy of Japan. The newly elected Prime Minister Yoshihida Suga said: "I want to continue Abenomics and enhance it".[11] Understandably, the promise to follow the policy platform of the Abe administration is the main reason for the election of Abe's chief cabinet secretary and son of a strawberry farmer, Yoshihida Suga, as the 99th prime minister of Japan.

[11] Shigeta, S (2020), "Suganomis' from A to Z: policies of Japan's PM front-runner", *Nikkei Asian Review*, 2 September 2020.