Understanding Japanese Deflation

工藤教孝

北海道大学経済学研究科

Abstract

This paper attempts to explain Japanese deflation as a fiscal phenomenon. The key observation is that the government is attempting to roll over the debt at a rate considerably higher than the growth rate of income, relying heavily on the short-run bond seigniorage; this strategy leads to non-existence of steady-state equilibrium. The real interest rate increases over time on the divergent equilibrium, and the central bank has to choose a combination of nominal interest rate and inflation rate. If the central bank follows low-interest policies, then the economy is deflationary until a new, sustainable fiscal regime kicks in.