How should we interpret Japan's persistent mild deflation despite monetary expansion and growing public bonds?: A rare, but catastrophic event as a trigger of an escape from a liquidity trap

January 2019
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Abstract: A combination of mild deflation despite monetary expansion, growing public bonds under continuing primary deficits, and near-zero short-term yields together with upward-sloping yield curves, which has been persistently observed in Japan's long-run deflation since the mid-1990s, may be explained as temporary liquidity trap phenomena, but it is difficult to be justified as a long-run equilibrium. This paper presents a simple monetary model in which such persistent deflationary phenomena are supported by the expectation of a rare, but catastrophic event, where the price level will jump up sharply, public bonds will be devalued heavily in real terms, and aggregate output will decline disastrously. According to the calibration result given rare, but catastrophic events such as a large-scale Tokyo inland earthquake, the current price is much less than one third of the long-run equilibrium price, while much more than one half of the real valuation of public bonds is sustained by unfunded components.

Key words: the fiscal theory of the price level, the quantity theory of money, non-Ricardian fiscal policy, mild deflation, yield curves.
JEL classification: E31, E41, E58, E63.