

Japanese Macroeconomic Policy Management after the Global Financial Crisis

Tokuo Iwaisako, Ph.D.
Principal Economist
Research Department
Policy Research Institute, Ministry Finance
tokuo.iwaisako@mof.go.jp

Japan and the Global Financial Crisis

- Japanese financial institutions had not been involved in US subprime loan problem as deep as Western financial institutions.
- So Japanese economy was relatively unharmed from the initial shock of global financial crisis.

Why was Japanese economy hit so late and so hard?

- Japan have had its own problems:
 - Low productivity growth
 - Delay in the structural reforms
- Japan had been relying on export demand during the recovery in mid 2000s.
- A significant decline of export demand hit the country so hard.
 - GDP growth in 2008:4Q & 2009:1Q averaged -10.0% in annual rate.

Developed countries' responses to the global financial crisis

- Monetary policy.
 - Emergency supply of liquidity and/or credit (micro).
 - Lower interest rate to stimulate economy (macro).
- Expansionary Fiscal Policy
- There are differences:
 - Increasing expenditure or tax cut
 - Europeans are more conservative than Japan and the U.S.
- Salvation and temporary nationalization of financial institutions in some countries.

Macroeconomic policy management after the global financial crisis

- Post crisis policy responses so far have been successful.
- Obviously, it is still far from over.
- There are many lessons and unsolved problems for macroeconomists as well as for policy makers.
- Instead of providing economic numbers, it will be more useful to illustrate Japan's macroeconomic policies from comparative perspective.

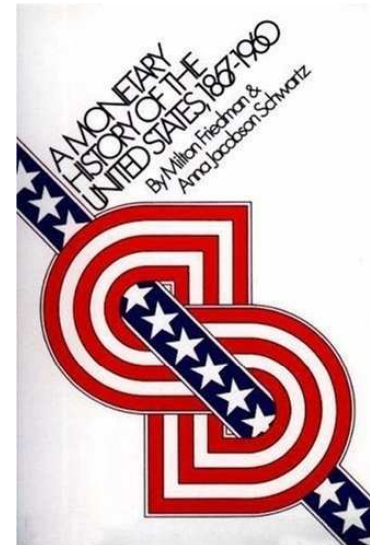
US policy responses

- Transition of administration: Bush to Obama
 - (Like Hoover to Roosevelt) Republican to Democrat
 - Transition of economic policy regime / philosophy: new Libertarian (ala M.Friedman) to interventionism (Keynesian?)
- Before the crisis...
- There was macroeconomic (New Keynesian?) consensus
 - Monetary policy is effective only at the right side of natural rate.
 - More favorable to monetary policy than to fiscal policy.
 - Eg. Bernanke, John Taylor, Blanchard, Mankiw.
- Great moderation
 - Disappearance of business cycle after Volker deflation in early 1980s
 - Consensus in economic ideas vs great moderation: chicken or egg?

Echoes from the past

On main causes of the Great Depression in 1930

- Friedman and Schwartz:



Monetary policy in early 1930s was too conservative.

- Death of Benjamin Strong, chair of NY FED, and the lack of leadership in FRB.
- Great Depression was a economic disaster caused by human errors.

Post Friedman-Schwartz: Modern consensus

- Bernanke (1983, AER):
 - Waves of banking panics in 1930 to 1933 broke down of the function of financial intermediation.
 - Resulted in sharp decline of the money multiplier.
- Eichengreen and Sachs (1985);
Eichengreen (1992)
 - Policymakers around the world put too much emphasis on gold standard, i.e., Golden Fetters.
 - Countries abandoned gold standard earlier recovered earlier.

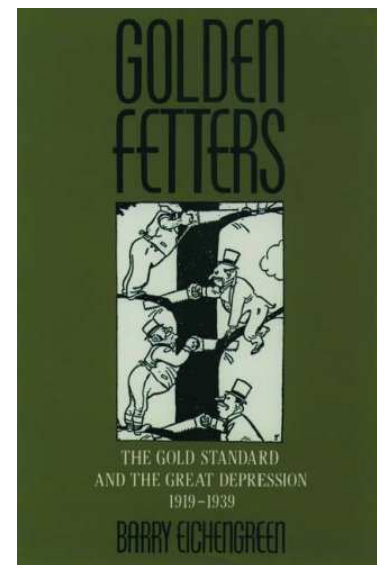


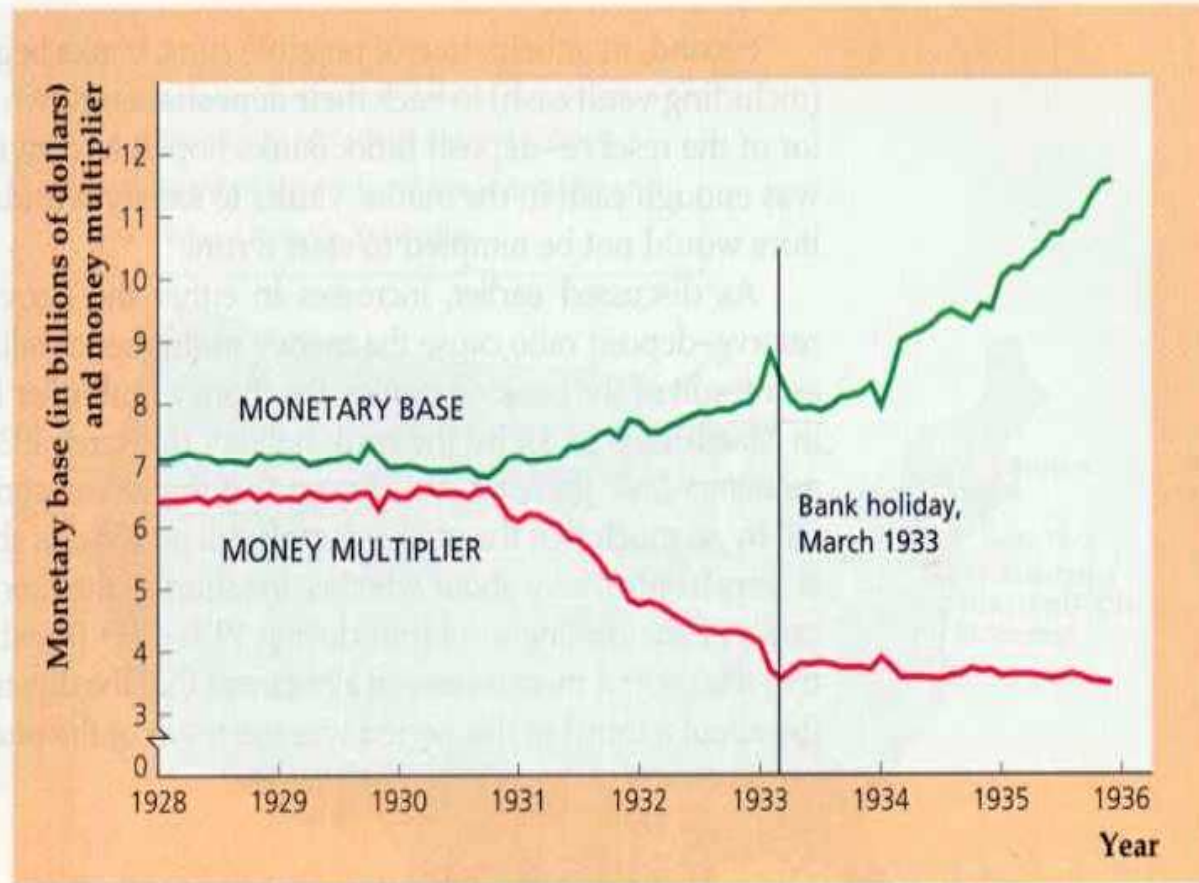
Figure 15.2

Monetary variables in the Great Depression

(a) As a result of the increases in the currency–deposit ratio and the reserve–deposit ratio, the money multiplier fell sharply during the Great Depression. The monetary base rose during the Great Depression.

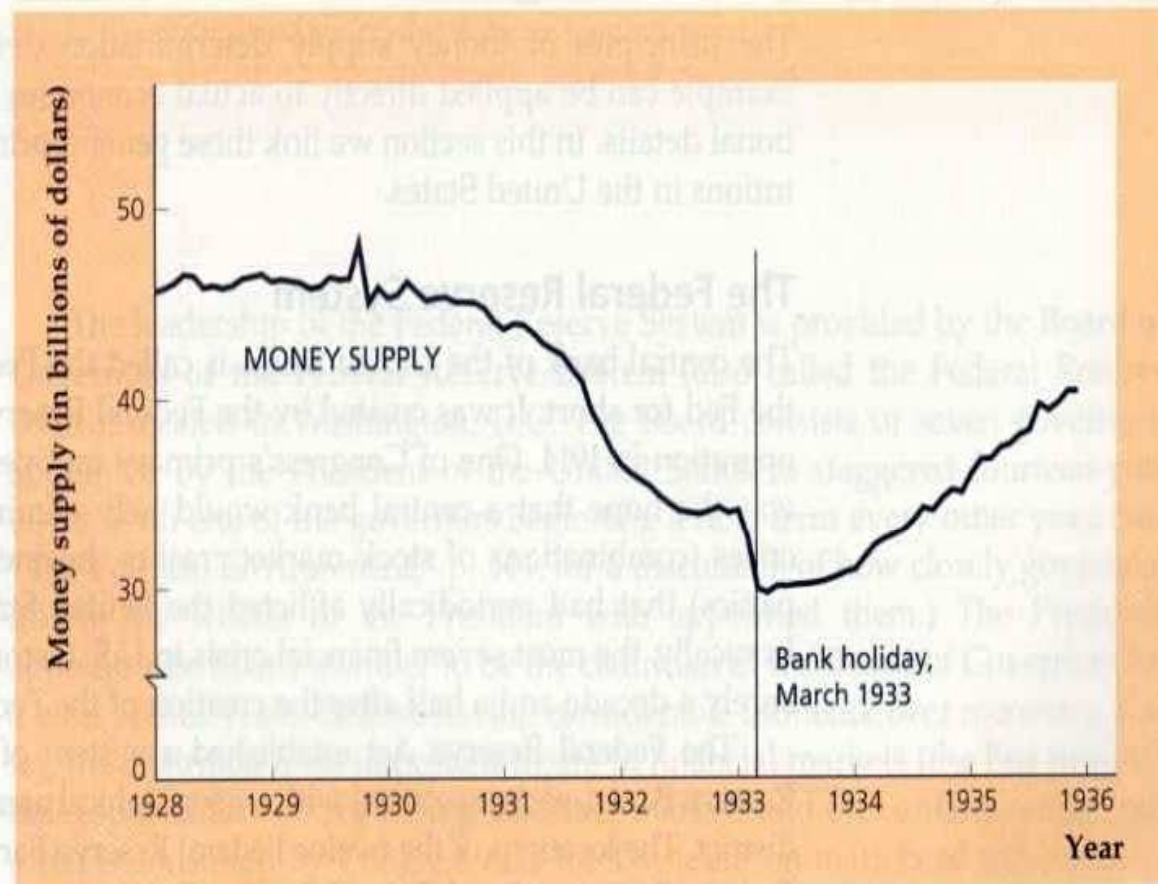
(b) Although the monetary base rose during the Great Depression, the money multiplier fell so much that the money supply—the product of the money multiplier and the monetary base—declined sharply.

Source: Milton Friedman and



(a) The monetary base and the money multiplier in the Great Depression

Anna Schwartz, *A Monetary History of the United States, 1867-1960*: Currency—Table A-1, column (1); deposits, total commercial banks (demand and time)—Table A-1, column (4); bank reserves—Table A-2, column (3); base = currency + reserves; money multiplier = (currency + deposits) / base; money = currency + deposits.



(b) The money supply in the Great Depression

Bernanke on Milton Friedman's 90th birthday



“Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again.”

<http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021108/default.htm>

European responses

Over time we have learned that:

- European financial institutions were much more deeply and directly involved in US subprime loan problem.
- Their own problems: Real estate bubbles in some countries (e.g. UK, Spain); Investment boom to East European countries (From Germany, France, Austria; To Latvia and etc.)
- Their priority is the Euro: keeping Euro's credibility as an international currency is absolutely important for them.

Euro and European macro policies: *Euro Fetters?*

- Euro area is not an optimum currency area
 - Even Europeans admit it.
 - But, Euro area has keep widening since its start.
- Their motivation is beyond pure economics.
- To maintain the credibility of Euro, the member countries have to avoid inflation and maintain fiscal discipline
 - If a country could not keep this commitment, their bargaining power in EU will be significantly lowered or will not be accepted as a member country.
 - Giving up an option to devalue own currencies significantly limit policy options in smaller countries.
 - Eg. Greece

Exit policies: US vs Europeans

- US: FED and White House want to avoid double dip recession caused by early exit from emergency scheme
 - Partly, practical decision.
 - US experience about the Great Depression has such an important influence on US policy makers (e.g. Bernanke Summers)
 - Mild inflation and devaluation of US dollar's value are acceptable for them.
 - So they demand currency appreciation to China.
- EU: Credibility of Euro is the top priority
 - They prefer early exit.
 - But, it can make European recession longer
- If other things are equal, the order of exit will be Europeans → US

Japanese Macroeconomic Policy: Fiscal Policy

- Both, previous LDP and current democratic party administrations acknowledge the importance of fiscal stimulus under the emergency situation.
 - Their priorities in fiscal expenditures are different.
 - LDP: investments to social infrastructure.
 - Current administration emphasizes children and educational support.

Japan's Fiscal Problem

- However, our debt-GDP ratio is worst among developed economies.
- For the long-run, fiscal reconstruction is top priority of Japanese macroeconomic policy.
 - Note that the increase of debt/GDP ratio cause by rapid aging of the society is not necessarily a bad thing.
 - Japan is a leading example of rapidly aging East Asia. Comparison with Western countries is misleading.

Fiscal policy for the short-run and medium run (1)

- For immediate future, improving the efficiency of fiscal expenditure is more important than decreasing absolute level of spending.
- E.g.: Budget screening operation by reviewers in public (so-called, *Jigyō-shiwake*)
 - It has contributed to improve the efficiency by increasing the transparency of budget planning process.
 - Public are generally favorable to the new screening process.
 - At the other end of the government projects that will face the budget cut, there are private companies so dependent to government related businesses that cannot survive without them.
 - It is necessary for the long-run, but short-run effect will be inevitably negative.

Fiscal policy for the short-run and medium run (2)

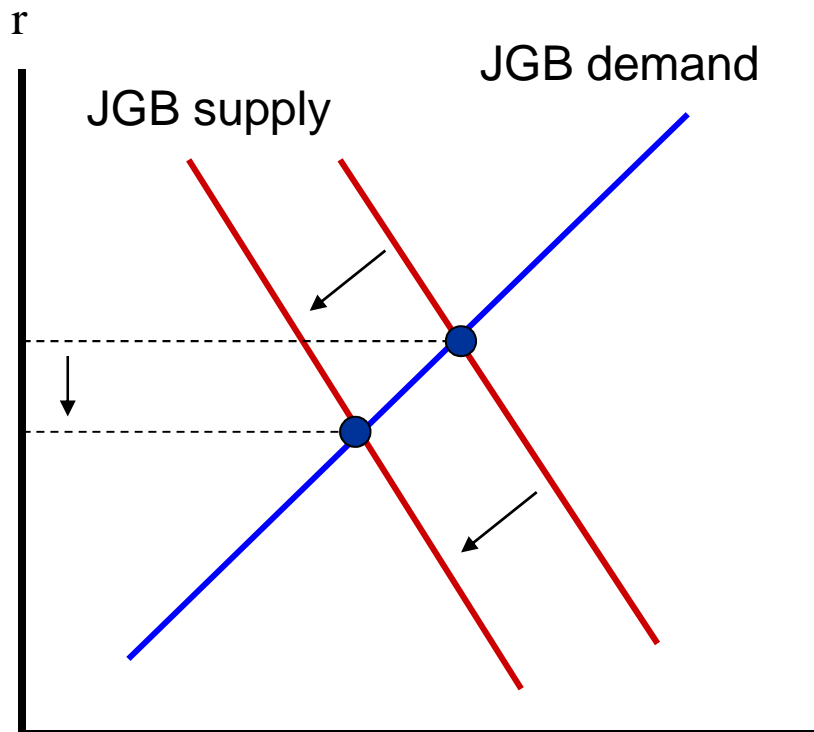
- Government expenditures promoting long-term growth of Japanese economy
 - Children and educational support
 - Who are the targets? How do we implement the goal?
 - Promotion of science and technology.
 - They are important and meaningful. But, it will take some time before those policies to contribute to economic growth.
- In the short-run, further increase of government debt is unavoidable

Possibility of Non-Keynesian Effect in Japan

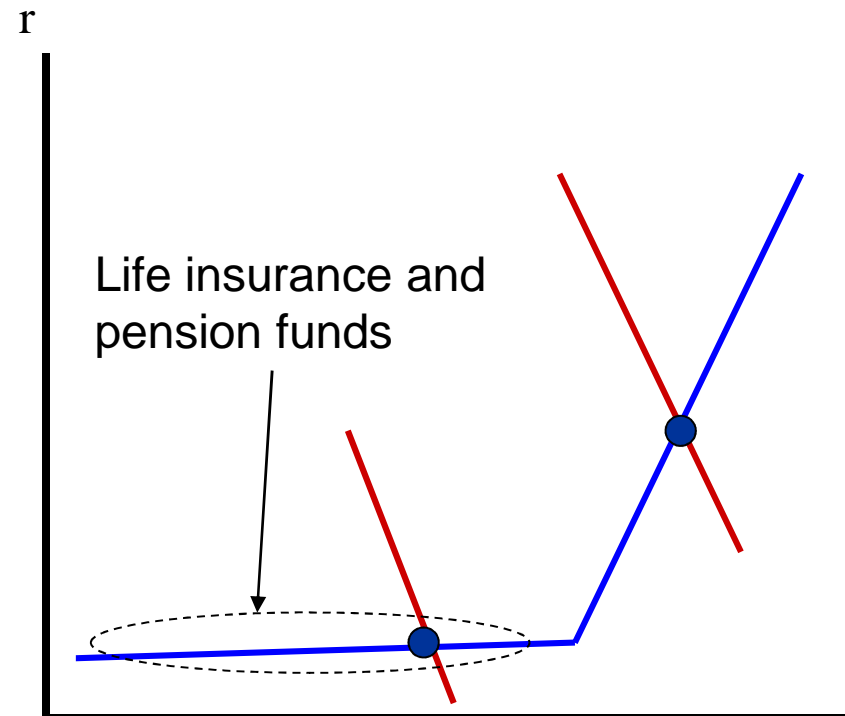
- Direct effect of decrease of fiscal expenditure
(zero or negative)
 - With very forward-looking (Ricardian) households, there will be no effect
 - If there are some Keynesian households, the effect will be obviously negative.
- Decline of interest rate by reduction of government debt
(positive)
 - However, Japan's long-term interest rate has been already low. So there is little room for further decline.
 - Cf. Life-insurance companies and pension funds.
- Improvement of the efficiency of fiscal expenditure
(positive)
 - There will be positive effect. But, a lot of uncertainty and time-lags.

Non-Keynesian effect by interest rate channel.

Non-Keynesian effect
(eg. European countries)



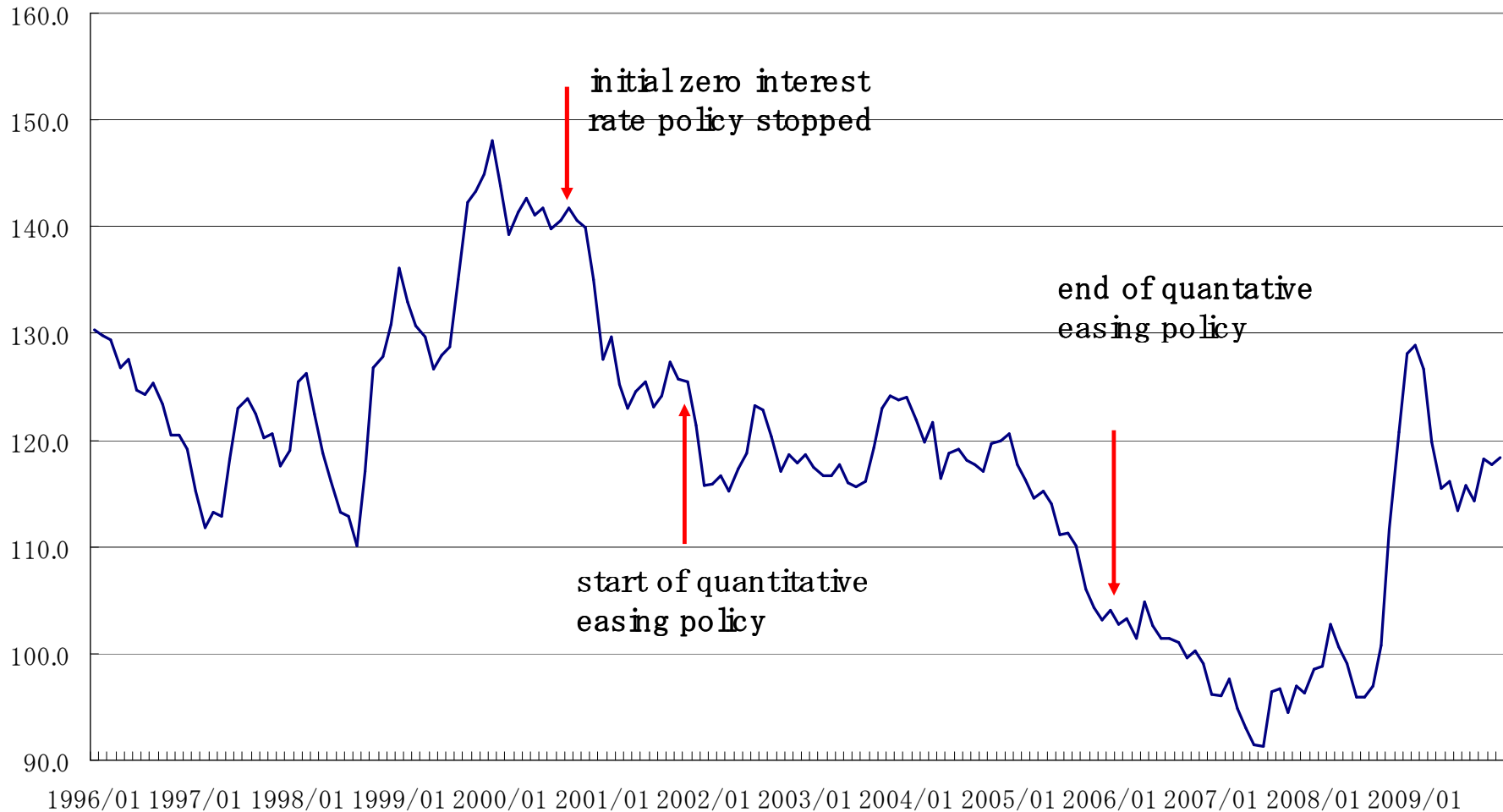
Long-term JGB market



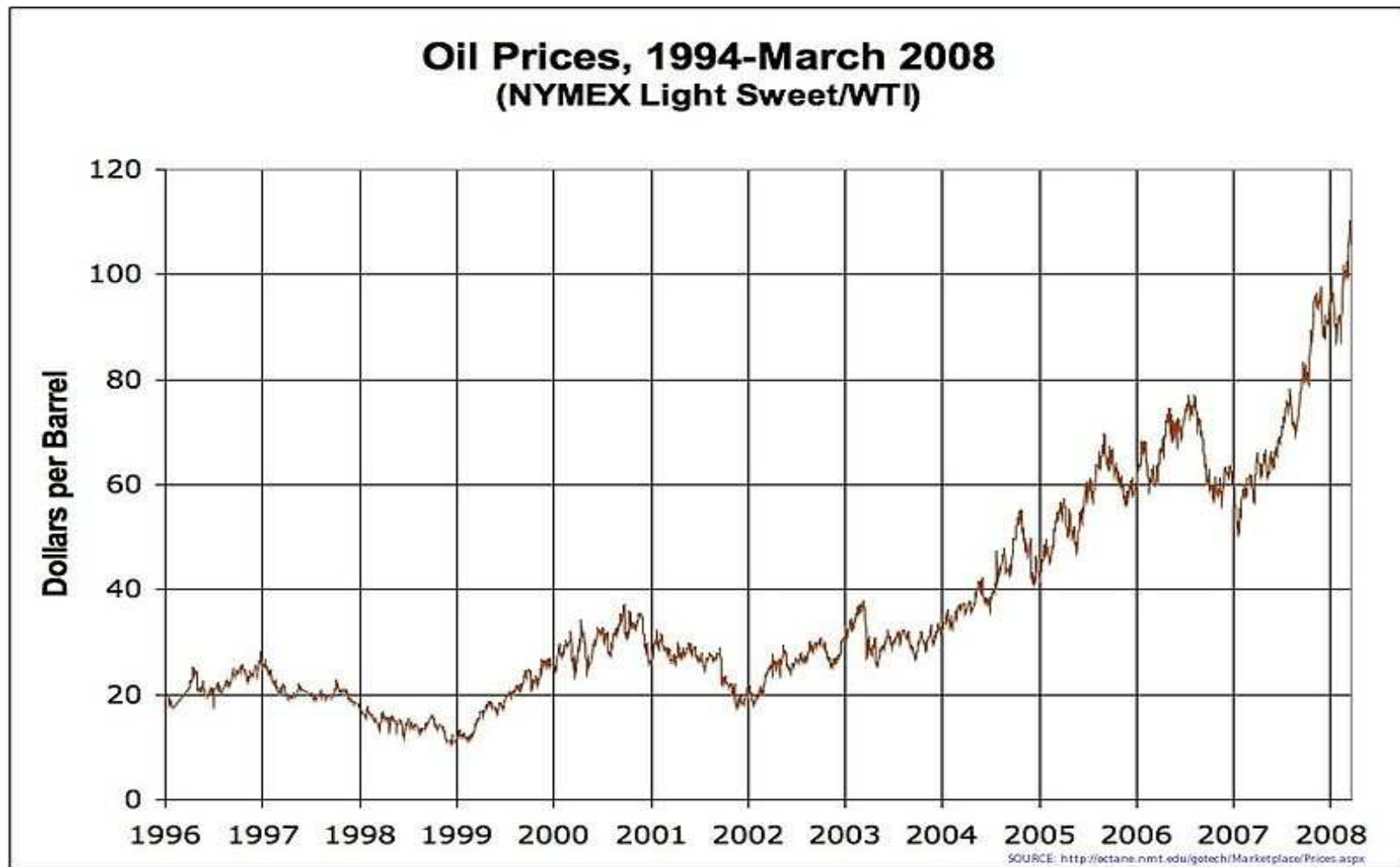
Monetary policy

- Bank of Japan's quantitative easing policy: 2001-2006
 - BOJ's judgment: not very effective as a macro stimulus policy
 - (Mostly foreign) observers:
BOJ was never serious about it.
- Why had Japanese economy recovered (to some extent) in mid 2000s?
 - Restructuring of non-performing loans.
 - Autonomous improvement (success of structural reform policies by Koizumi administration?)
 - Strong export demand due to world economic boom and weak yen.
 - Or actually quantitative easing policy worked.

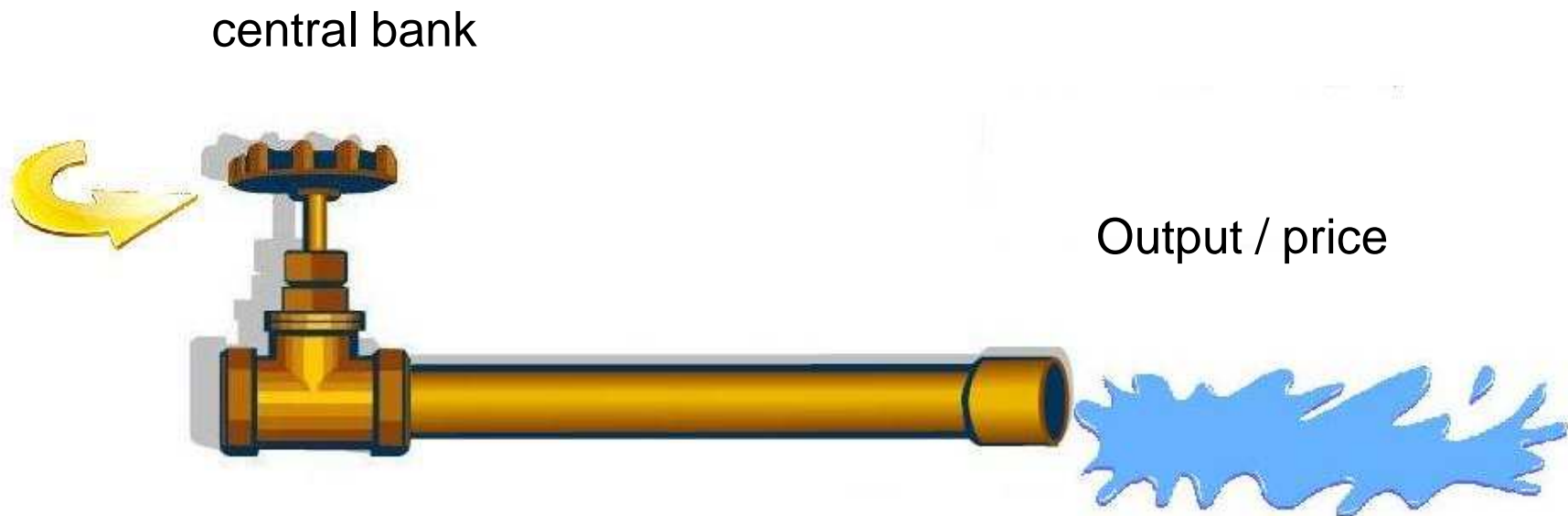
Real effective rate of Japanese Yen: 1996-2009



Oil price movement



Monetary policy : in simple IS-LM world

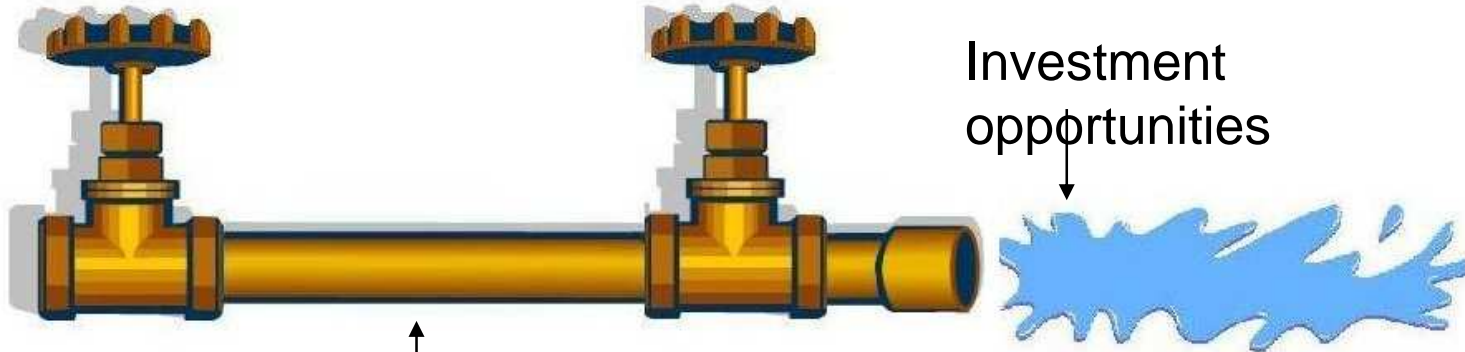


Monetary policy : more realistic setting

Base money /
short-term
interest rate

Expectation of
public

Investment
opportunities

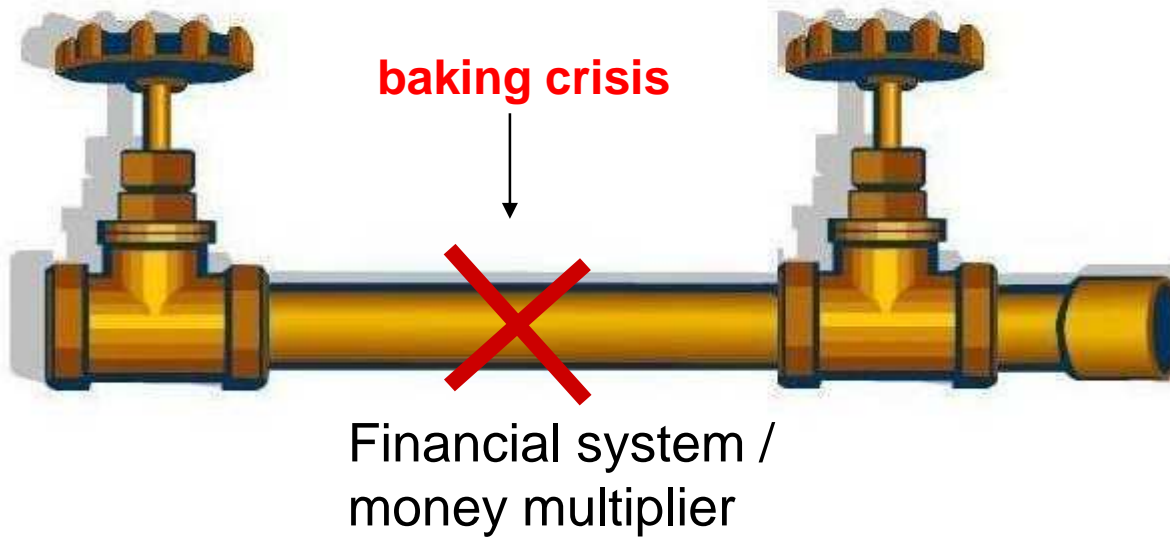


Financial system /
Money multiplier

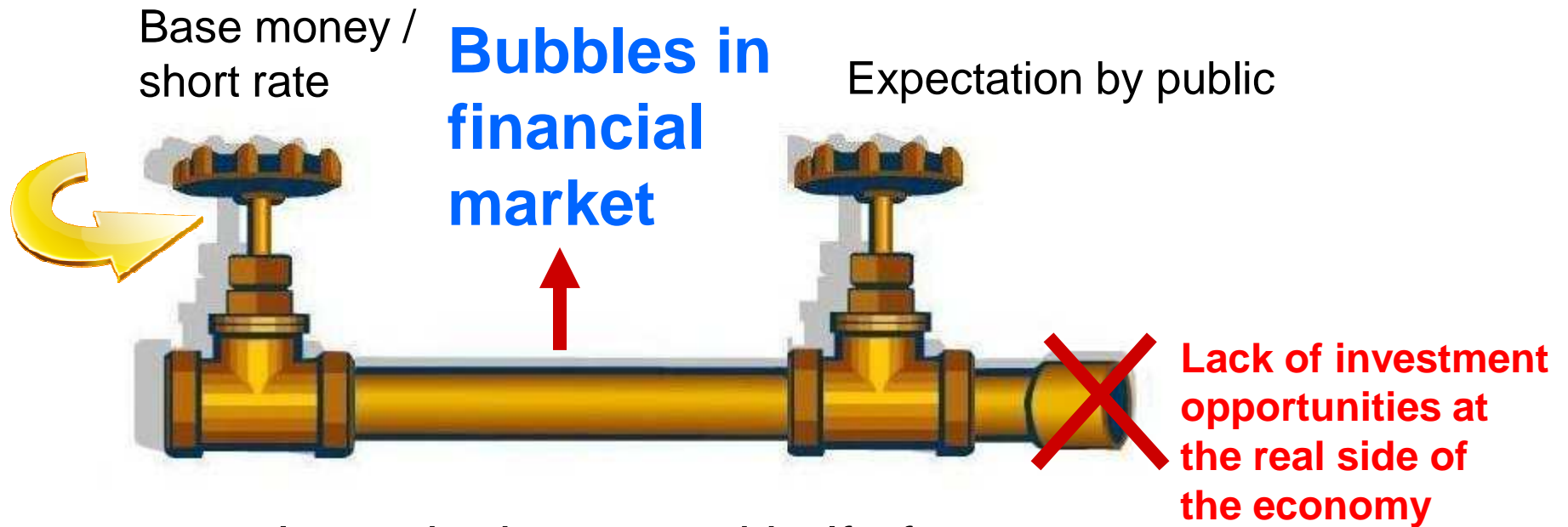
Banking panic and/or credit crisis

Base money

Expectation of public



Lack of good real investment opportunities



- Japan in the second half of 1980s
- Great moderation (?)
- Current US economy

Exit policy: US vs Japan

- Intentionally or not, US monetary easing tends to lower the value of dollar.
- Current level is not too low for US. So there will be no joint intervention to prevent further appreciation of Yen.
- Japan has to keep monetary easing until US exits from the emergency policy regime (unless Japanese domestic economy recovers strongly by a miracle).
 - Problem: US monetary easing
→speculations in commodity markets
- Order of exit: Europe → US → Japan

Possible disturbances in the order of exit policy

- US: Real economy is not responding to aggressive monetary policy
 - FED wants to instruments to directly affect and curb speculations in asset markets. However, congress is reluctant.
- Europe: Modern Greek tragedy
 - The possibility of break down of Euro is slim. But, some speculators seem to start betting on it.
- Above all, there is an increasing concern for large sudden adjustment in Chinese economy.

Problems to be answered

- Difficult tradeoffs in monetary policy
 1. Keep inflation rate and inflation expectation at very low level.
 2. Provide enough monetary easing to stimulate the economy.
 3. Avoid asset bubbles in financial markets.
 - Greenspan: #1 & #2
 - Bank of Japan: #1 & #3
 - Bernanke: monetary policy for #1 & #2. But, wants other policy instruments to do #3.
- More microeconomic evidence on price adjustment mechanism and inflation expectation.
 - Something beyond modeling devices (such as menu cost or time-dependent pricing)
 - Has DSGE been really useful in explaining the real world phenomena?