

Japanese Macroeconomic Policy Management after the Global Financial Crisis¹

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Tokuo Iwaisako, Ph.D.

Principal Economist
Research Department
Policy Research Institute, Ministry Finance
3-1-1 Kasumigaseki
Chiyoda-ku, Tokyo 100-8940, JAPAN
tokuo.iwaisako@mof.go.jp

Abstract

This paper provides an overview of macroeconomic problems that Japanese economy facing after the global financial crisis and discusses Japan's policy responses, emphasizing the comparison with the United States and European countries.

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1. Introduction

The financial crisis that started in 2007/08 triggered an unprecedented deterioration of the global economic condition. Japan, along with other East Asian countries, was relatively far from the ground zero of the initial financial crisis triggered by the subprime loan problem in the United States. Japanese economy was relatively unharmed until the last quarter of 2008. Then, suddenly, a significant decline of foreign demand and the sharp appreciation of yen's exchange rate hit the country, which had become so dependent to export through 2000s. Japanese economy suddenly stepped the breaks in the fourth quarter of 2008 and the first quarter of 2009, resulting in averaging negative GDP growth less -10.0% in annual rate for this six month period.

Responding to the global economic crisis, major countries lowered interest rates and took fiscal measures, as well as microeconomic policy responses to preserve their financial systems and financial institutions. In this paper, instead of directly describing Japan's macroeconomic policies, I compare Japan's economic conditions and its policy responses with those in European countries and in the United States. I believe this strategy is more effective for two reasons: First, developed countries are facing more or less similar problem --- deteriorating fiscal condition and zero interest rate bound are common limits to their monetary and fiscal policies. Comparison of with other developed countries facing the similar difficulties will help to illustrate the characteristics of Japan's problems and corresponding policy responses as well as potential policy alternatives. Second, I believe it is imperative to understand countries political climates and basic philosophies toward economic policies, to understand different conducts of macro economic responses. Making comparison with other countries is the easiest way to do this.

In the following, first, I review macro policy responses of the United States and of European countries, emphasizing the contrast between aggressive US policy stance and conservative European policy responses. Then, I discuss Japanese macroeconomic problems after the global financial crisis: short-run fiscal policy responses, long-run fiscal problem, and monetary policy at near zero-interest rate bound.

2. Macroeconomic Policy Responses in the United States and Europe

2.1 The United States

Barack Obama's inauguration as the President of United States in 2009 parallels Franklin Roosevelt's in 1933 in many ways, including in terms of America's macro economic policy management. Both Obama and Roosevelt are democrat presidents succeeding republican presidents, namely Bush and Hoover. Change in the political climate explains why US fiscal expansion after the global financial crisis has been so aggressive.

However, to understand US response in monetary and financial policy, focusing on continuity and tradition are much important. The Great Depression in 1930s is such a huge landmark in US economic history so that it still has such large influences on academics and policy maker in 21st century. While there is a sharp rivalry on the effectiveness of fiscal policy, the consensus on monetary policy seems to be solid and profound.

Friedman and Schwartz's *A Monetary History of the United States, 1867-1960* is the milestone of the economic analysis of the Great Depression. In their book, Friedman and Schwartz emphasized the death of NY FED chairman, Benjamin Strong, and resulting lack of strong leadership within the Federal Reserve System facing the financial panics in early 1930s as the main causes of the Great Depression. While many people disagrees with Friedman and Schwartz about the importance of NY FED chairman's death, there is a wide and solid consensus about their main point that the failure of FED's monetary policy was the biggest cause of prolonged depression in the United States in interwar period.

The subsequent academic literature, basically complement, rather than replace, the main theme of Friedman and Schwartz. Bernanke's seminal article (1983) emphasized the wave of banking crises and the breakdown of financial intermediation which caused a significant decline in US money multiplier in first three years of 1930s. Eichengreen and Sachs (1985) and particularly Eichengreen (1992) emphasized the international dimension of the Great Depression. The "Golden Fetters" --- central banks' obsession to gold standard --- is singled out by Eichengreen and his coauthors as an important reason of muted monetary policy responses to the banking panics in early 1930s. The following quote from Bernanke's speech on Milton Friedman's 90th birthday reveals the important influence of Friedman and Schwartz's view on macroeconomists and policymakers in the United States today:

“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.”

Hence, it is not difficult to understand FED led by Bernanke has responded aggressively to the current global financial crisis. While FED faces some criticism and possible mini-bubbles in commodity markets because of loose monetary policy, FED is so afraid of possible double dip recession that too early “exit” policy might cause. If there is any bias in FED’s policy, it has to be over expansionary rather than over concretionary.

2.2 Europe

It was not easy to grasp what was going on in Europe from Far East since the coverage by media and researchers about this area are much more limited compared with about the US economy. However, we have learned European situations and their problems over time. First, European financial institutions had been involved in US sub-prime loan problem much more directly and deeply than we (i.e., Japanese and East Asian) people thought. Second, European countries have their own problems and they as much serious as US problems --- such as the collapses of real estate bubbles (e.g. Spain and UK) and the investment boom to East European transition economies (e.g. Latvia). Finally, for the majority of European countries, their top priority seems to be the credibility of Euro. Hence, fiscal discipline and low inflation are the backbones of macroeconomic policies for attaining this ultimate goal.

For outsiders in Far East, watching recent developments in troubled sovereign debts of Greece, European conservative macroeconomic policy management outstands in the contrast of much more aggressive policy stance of the United States. Their cling to Euro is obviously behind their policy attitude. To many European central bankers and politicians, the story is not just about economics, but politics, to maintain European unity, almost at any cost.

At this point, it is difficult to judge whether conservative European option or aggressive American option yields higher return for those countries in the long-run. There is no obvious answer to attain the balance between higher current economic growth and reconstructing fiscal situation. It is a difficult problem for both Europeans and the United States as well as for Japan. One thing obvious in near future is that, if other things are equal, European

exit from its emergency policy regime will be earlier than the United States.

3. Japanese Macroeconomic Policies

Japanese economy also faces the set of similar macroeconomic difficulties --- high debt-GDP ratio and extremely low interest rate. On the surface, Japanese problems are the worst among developed economies: its debt-GDP ratio is the highest and the short-term interest rate has been attached to the zero bound for ten years. However, unlike the United States and some European countries, Japan is still running for significant current account surplus and close to 95% of its government debts are held by domestic investors. This is good news for Japanese economy in the short-run, because the potential of the debt crisis is still remote despite of extremely high level of debt outstanding. It is bad news in the long-run, because Japan is basically transferring the burden to future generation.

3.1 Fiscal Policy Response to the Global Financial Crisis

To fight the deflationary pressure and sharply declining export, Japanese government took aggressive stimulus macro economic policies from the second half of 2008. Since the interest rate had been already close to the zero bound even before the global financial crisis, the burden of fiscal policy was inevitably higher than in other developed economies. Japanese government worked out a total fiscal budget of approximately 26 trillion yen including two supplementary budgets in FY2008, the initial budget of FY2009, and a subsequent supplementary budget. These budgets were worth around 130 trillion yen in terms of the size of the projects. On December 8, 2009, Japan took budgetary steps amounting to 7.2 trillion yen, which were worth 24.4 trillion yen in terms of the size of the projects, ensuring “emergency economy-boosting measures for a secure and growing future economy.” The national budget for FY2010, which passed in January 2010, saw a 4.2% increase in the general account compared with the previous fiscal year.

As a result of these expansionary fiscal measures, Japan has marked a positive real GDP growth in the third quarter of 2009 that is greater than any other major countries. It will take some time to properly assess the effectiveness of fiscal policy in 2009 and 2010 quantitatively. While the fiscal measures such as the subsidies for the purchase of energy

conserving home appliances (so-called, *Eco-point System*) have definitely contributed to boost the economy, it has been argued that the repeated fiscal stimulus and accumulating government debt since late 1990s have significantly lowered Japanese fiscal multiplier. On the other hand, in November 2009, Japanese government and Bank of Japan declared that they recognize deflation as the serious obstacle of the economy. Hence, it is difficult to claim that Japanese economy is now surely on a self-sustaining path of recovery.

3.2 Japan's Fiscal Problem

As an unavoidable side effect of these aggressive economic stimulus policies, Japanese budget deficit in relative to the GDP is soaring. Once again Japan's long-run fiscal sustainability comes to the focus of attentions among policy makers, academics, investors as well as general public. Real challenge is how to explore sustainable fiscal planning, while maintaining the current economic growth.

For the short and medium run, perhaps improving the efficiency of fiscal expenditure is more important than lowering the absolute level of budget deficit. For example, Hatoyama administration introduced the reviewers' budget screening operation in public (so-called, *Jigyo-shiwake*). Admittedly, there have been some important and relevant criticisms from various parties about how screening operation was conducted. However, new budget screening operation has definitely improved the transparency of budgeting process and general public's support is strong. New administration also declared to promote the policies increasing long-run economic growth such as children and educational support, promotion of science and technology. These policy targets are obviously important and meaningful for the long-run. However, it is difficult to expect their immediate stimulus effects on current macroeconomic performance. On the other hand, at the other side of the government businesses, projects, and programs that will face the budget cut by the restructuring of government expenditure are private businesses so dependent to government related businesses so that cannot survive without them. Hence, despite the fact that the restructuring and improvement of public expenditure is absolutely necessary for the long-run, such a policy reform will have a negative impact on aggregate economy in the short-run.

Let me restate the argument above in a more academic setting. In conventional macroeconomic analysis, the effect of fiscal reconstruction will be either neutral or negative. If we take the Ricardian equivalence on its face value, the government budget policy is neutral for

macro economic performance. However, more realistically, there are at least some myopic or liquidity constrained households (Keynesian consumers) in the economy. As a result, fiscal reconstruction will definitely have negative impact on macroeconomic performance in the short-run.

On the other hand, there a number of studies, mostly focusing on the experience in European countries, argue that fiscal reconstruction can be expansionary. Such a possibility is called “non-Keynesian effect” of fiscal expenditure. There are two primary channels by which reduction of government debt indeed stimulates aggregate output. First channel is through the lower interest rate. Large government debt typically associated with the high risk premium on sovereign debt, so that higher interest rate. Credible commitment to fiscal reconstruction can significantly lower the interest rate by reducing the risk premium on government bonds (Figure 1, Panel A). Lower interest rate will stimulate business investment in private sector so that will boost the real economy. However, such an “interest rate” channel is unlikely to work in Japanese case, because Japanese interest rate has been and will be at extremely low level.

This is because the Japanese economic environment described at the beginning of this section. Unlike Western countries, Japan is still running for significant current account surplus and dominant buyers/holders of its government bonds are domestic investors. These facts will be partly explained by the fact that aging in Japan is progressing so rapidly, but it not so obvious if aging explains entire story. In any way, there are two segments of investors in JGB market. The first is domestic investors whose demand curve is thought to be almost flat. The other group is foreign investors whose demand for JGB is much more elastic to the interest rate level (Figure 1, Panel B). Hence, current JGB interest rate is too low for the majority of foreign investors. Without such affluent domestic demand for JGB, Japanese interest rate must have been much higher so that recession could be even worse. In that sense, Japan has already used up the potential of non-Keynesian effects through interest rate channel.

Second possible channel is the improvement the efficiency of government spending by reducing unnecessary government projects. Perhaps, this is the only possibility by which fiscal reconstruction in Japan stimulates macro economic performance. However, as we discussed above, the positive effect of the efficiency gain of government spending will be the long-term phenomena. In the short-run, the direct Keynesian effect will dominate so that the budget cut will be inevitably negative.

3.3 Monetary Policy

Another important limit for Japanese macroeconomic policy is the ineffectiveness of monetary policy due to the zero interest rate bound. In the conventional framework of Keynesian IS-LM analysis, monetary policy works by lowering interest rate or increasing monetary base which will cause automatic and proportional increase in money supply (Figure 2). However, the real world is more complicated and central banks' ability to control money supply might be severely handicapped for various reasons. In order to generate proportional increase of money supply by increasing monetary base, the financial intermediaries such as commercial banks must be functioning properly. In an abstract expression, this means that the stability of money multiplier is necessary for effective monetary policy management as in the IS-LM analysis. As demonstrated in Bernanke (1983) banking panics will generate the break down of financial intermediation function in the economy and make money multiplier significantly lower and unstable (Figure 3).

The discussions so far can be found in standard textbooks in macroeconomics (e.g. Abel and Bernanke) or monetary economics (e.g. Glenn Hubbard). However, when short-term interest rate hits the zero lower bound, conventional monetary policy will not work. As unconventional monetary policy measures in such an environment, monetary policy regimes such as quantitative easing and inflation targeting have been discussed extensively and implemented in some extent. The effectiveness of such unconventional policies is an important topic, but is beyond the focus of this paper. Instead, I will briefly discuss the implications of recent monetary policy debates and the experiences of Japanese economy and US economy in the following.

Since the high inflation period in 1970s, fighting inflation became a top priority of central banks of the developed economies around the world. By late 1980s, most of them achieved this goal and enjoyed the subsequent period so-called "Great Moderation" until several years ago. Great Moderation has been often attributed to "improved" policy management by central banks, but, by now, it is obvious that there are important adverse side effects with central banks monetary policy regime in this period. Both Japanese asset price bubbles in late 1980s and US subprime loan problem are preceded by the period of loose monetary policy and low inflation rate. More specifically, Bank of Japan after Plaza Accord of 1985, loosened monetary policy while committing strongly to low inflation rate, to accommodate negative impact of sharp appreciation of Yen's exchange rate. Greenspan similarly cut the interest rate in a drastic manner after the collapse of IT bubble at the beginning of this century, while maintaining his

commitment to low inflation. The results are that, instead of boosting the real side of the economy directly, low interest rate created speculations in asset markets in both cases. In retrospect, it was the wealth effects of asset bubbles that contributed sustained growth of real side of the economy.

Policy makers' intention was to balance between low inflation and strong economic growth. However, it turned out that pursuing this goal tends to generate speculations in asset markets. Monetary authorities around the world learned the lesson in hard ways that they have to consider the trilateral balance among inflation, real economic growth, and financial euphoria in asset market at the same time (Figure 4).

There are several important issues that have to be examined about such a trilateral balance problem. First, the combination of low inflation commitment and loose monetary policy does not always necessarily create asset bubbles. In the case of Japan's bubble economy, in retrospect, the real side of the economy had been suffering from low productivity growth as early as the first half of 1980s. So the lowering interest rate created the supply of funds/credits that could not find good investment opportunities in the real side of the economy. Such an excess supply of credit found its borrowers in real estate markets. Bernanke's FED seems to be facing the similar problem. While FED's monetary policy has been so aggressive since onset the financial crisis in the fall of 2008, the real side of the economy has not really respond yet because real side of US economy damaged so severely. Meanwhile, since the summer of 2009, speculative money has started to play with commodity markets once again. FED's dilemma is to tighten monetary policy to curb further speculation or keep pumping money into the financial system to avoid potential double dip recession. Overall, it is not so obvious that which is more important, low inflation expectation/commitment or the lack of good investment opportunities in the real side of the economy, in creating asset price bubbles.

Second, what will be the best practical solution for central banks to deal with such a trilateral balance problem? Current response by Bank of Japan seems to be putting more weights on low inflation and avoidance of speculation, rather than economic growth. US Federal Reserve seems to be exploring real economic growth more aggressively, while exploring the use of some other microeconomic measure to directly curb excessive risk taking by financial institutions. However, by all regards, it is too early to judge that if FED's attempt will succeed or not.

Related third question is that, given that we use direct microeconomic regulation to fight with speculations in asset markets, who is the best authority to responsible for such policy measures. One opinion in current discussion on US financial regulatory reform is that it should be FED since it is difficult for the regulatory bodies like SEC to make a short-term economic judgment such as if the “bubble” component in current asset price is too large. However, it is also true that FED is largely responsible in creating the financial euphoria in the sub-prime loan problem. There are many economists and politicians who are critical to FED about this point, so that oppose to give FED such an authority.

4. Conclusions

This paper analyzed current Japanese macroeconomic environment and policy challenges from the comparative perspective. Let me conclude it by discussing the timing of “exit” from emergency policy regime in Europe, Japan, and in the United States.

As discussed above, for being other things are equal, Europe will prefer the exit from current policy regime as soon as possible. Hence, it is most likely that ECB will increase the interest rate prior to FED. Bank of Japan, on the other hand, have relatively limited choices. In 2006, when BOJ stopped the quantitative easing regime of monetary policy, real exchange rate of the Yen was at the level as low as right before Plaza Accord in 1985 and the foreign export demand was booming. Yen has bounced back and external demand has plunged into the trough. As long as FED keeps its interest rate low and puts downward pressure on the value of US dollar, Japan has no choice to get along with the United States, unless domestic economy miraculously revamps and recovers.

However, there are too many uncertainties in this scenario. European troubles seem to be getting worse. It is possible the United States will recover first by keeping loose monetary policy and lowering its currency to help adjustments. More unlikely, but it is also possible that Japan will recover even faster if Asian emerging economies continue to recover and grow, so that Japan’s export to those country accelerates. However, the biggest uncertainty right now for the Japanese economy is that if Chinese economy will continue to grow at current speed. It is difficult to expect that China will completely fall back to the underdeveloped economy, but many expect some large adjustment is unavoidable. How large will the adjustment and the effect

to Japanese economy be are major concern for Japan and majority of East Asian countries.

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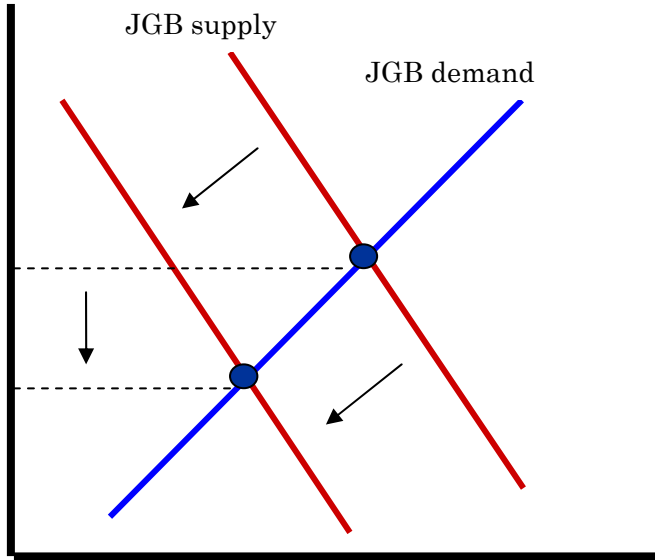
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Figure 1

Non-Keynesian Effect of Fiscal Restructuring through Interest Rate Channel

a. How Non-Keynesian is supposed to work

interest rate



interest rate

b. Current Japanese situation

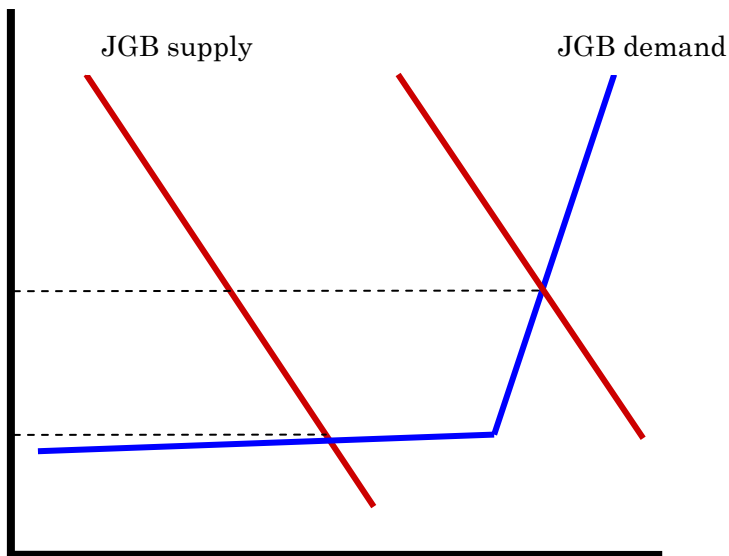


Figure 2
Monetary Policy in Old-Fashioned IS-LM Framework

Increase of monetary base
/ lower discount rate

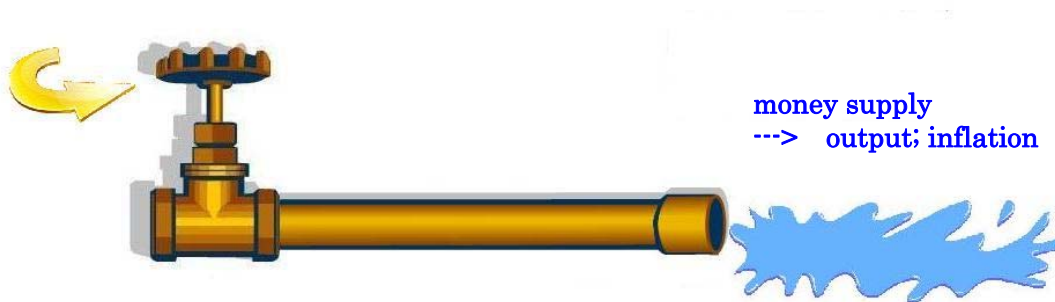


Figure 3
Monetary Policy in a More Realistic Framework

monetary base / discount rate



Figure 4
Monetary Policy and Asset Bubbles

