CGP Part (2) Abstracts

Macro/Financial Issues and International Economic Relations: Policy Options for Japan and the United States

A. Assessment of Japan's Macro/Financial Policies and Proposals for Reform

Michael Hutchison, University of California, Santa Cruz, "Regime Changes in the Monetary Transmission Mechanism in Japan: Implications of the Zero Interest Rate Policy and Banking Crisis"

This paper will investigate whether shifts in monetary transmission in Japan have contributed to the duration and depth of the recession since the mid-1990s. The main question to be addressed is whether the continuation of the banking crisis has caused the monetary transmission mechanism to fail, resulting in turn in rapid base-money growth but falling broad money and credit growth in Japan. It appears that there is a clear drop in the money multiplier (link between base money and the broader money aggregates), but it is not clear whether this is associated with a dysfunctional banking system—effectively hindering monetary impulses to aggregate demand—or with a liquidity trap situation that may occur when nominal interest rates are at zero. This paper will present a structural vector auto regression model that is able to capture shifts in the monetary transmission mechanism and evaluate the effectiveness of monetary policy working through three main channels of transmission: the credit channel; the interest rate channel; and the monetary aggregate channel.

Toshihiro Ihori, University of Tokyo, "The Political Economy of Japan's Fiscal Reform"

This paper will first investigate Japan's fiscal policies in the 1990s and then consider the macroeconomic impact of government debt and the sustainability problem since fiscal sustainability has become a serious issue. Also to be considered are the fiscal reconstruction movements from the politico-economic viewpoint. An important lesson from Japan's fiscal policies in the 1990s is that, in order to realize successful fiscal reconstruction, the central government needs to restrain the lobbying activities of local political groups. The paper will investigate the dynamic properties of intergovernmental financing during the fiscal reconstruction process by analyzing the game among local governments with concessions of region-specific transfers in the concept of soft budget constraints.

Alan G. Ahearne, Board of Governors of the Federal Reserve System, and Naoki Shinada, Development Bank of Japan, "Zombie Firms and Economic Stagnation in Japan"

It is often claimed that one contributing factor to Japan's weak economic performance over the past decade is that Japanese banks have continued to provide financial support for highly inefficient, debt-ridden companies, commonly referred to as "zombie" firms. Such poor banking practices in turn prevent more productive companies from gaining market share, strangling a potentially important source of productivity gains for the overall economy. To explore further the zombie-firm hypothesis, this paper will present a simple model of "creative destruction" in which a poorly functioning banking system keeps inefficient firms in operation by subsidizing their losses. Using industry- and firm-level Japanese data, empirical evidence suggests that productivity growth is low in industries reputed to have heavy concentrations of zombie firms. Also, the reallocation of market share may be going in the wrong direction in these industries, adding to already weak productivity performance.

Masahiro Hori and Satoshi Shimizutani, Economic and Social Research Institute (ESRI),“ What Changes Deflationary Expectations? Evidence from Japanese Household-Level Data”

The Japanese economy has suffered from deflation since the mid-1990s. Despite the importance attached to overcoming deflation on the part of policy makers and academics in Japan, there has been no recent research on the factors that may change deflationary expectations. This paper will draw upon a unique and rich quarterly household-level data set to estimate average price expectations, what changes price expectations, and how changes in price expectations affect household consumption. Our preliminary empirical estimates indicate that price expectations in Japan range from minus 0.5% to 0.0% for the period from 2001 to 2003, with the exception of a large increase in the first quarter of 2003 due to the Iraq war. Price expectations are found to depend on current price movements and lagged expectations. Awareness of monetary policy announcements does not greatly change price expectations, since it appears that a series of measures of quantitative easing resulted in only a small percentage (5-10%) of people surveyed revising their expectations. We also confirm that deflationary expectations discourage household consumption, mainly durables, through postponing the timing of purchases.

Gary R. Saxonhouse, University of Michigan, “Good Deflation/Bad Deflation and Japanese Economic Recovery”

Japan has been suffering from deflation for the past five years. The Bank of Japan (BOJ) has been arguing strenuously that Japanese deflation’s roots are structural, not macroeconomic in origin. According to the BOJ, Japan has been undergoing profound structural change. With deregulation both domestically and at the border, the Japanese economy is far more competitive than it was even just a few years ago. This has resulted in very significant changes in Japan’s price structure that shows up in Japan’s price indices as deflation. Rather than a policy problem requiring remedy, the BOJ views such deflation as a positive development. The BOJ analysis relies very heavily on their finding of a lack of synchronization of price changes in Japan during the past five years. They argue that if Japan’s deflation were macroeconomic in origin there would be a close correlation in goods-price changes across sectors. Using data from other countries, this paper will examine whether this is a reasonable characterization of how macroeconomic forces influence an economy’s price structure. Using Japanese data, the paper will also examine the extent to which the BOJ’s characterization of the pattern of price change in Japan is correct.

Masahiro Kawai, University of Tokyo, “Reform of the Japanese Financial System”

The Japanese financial system has been in difficulties since the early 1990s. The paper will describe the state of the banking sector for the period 1980-2003, examine the causes of the financial system difficulty, outline and evaluate the policy responses that have been taken to resolve the banking system difficulty, discuss and evaluate the policy initiatives to accelerate corporate sector restructuring, and offer policy challenges for further financial and corporate sector restructuring/reform.

B. *Traditional and Unconventional Macro/Financial Policies to Promote Economic Recovery*

Stephen Cecchetti, Brandeis University, "Nonstandard Monetary Policy: What To Do When Overnight Interest Rates Go To Zero"

The central banks of the industrialized world have succeeded in reducing inflation to levels that approximate price stability. But low inflation means low interest rates, limiting the expansionary ability of monetary policy. This paper will critically examine the theoretical and empirical evidence on the efficacy of policymakers' alternatives when the traditional interest rate instrument – the overnight interbank lending rate – reaches zero. All of these involve alternative methods for expanding the central banks' balance sheet. The paper will consider various methods, including the quantitative easing strategies employed by the Bank of Japan and the yield curve policies discussed by the Federal Reserve, as well as the Hong Kong Monetary Authority's decision to purchase equity. The central question is whether there is a function mechanism that transmits such central bank actions to the real economy.

Takatoshi Ito, University of Tokyo, "Yen Depreciation and Japanese Economic Recovery"

The Japanese economy has been stagnating in the last eleven years. The economy experienced the bursting of the real estate and stock-price bubbles, problems of nonperforming bank loans, the financial crisis of 1997-98, deflation since 1998, and an information technology (IT) bubble that burst in 2000. However, policy mistakes were also evident. The easing of monetary policy has always been late, with a glaring mistake of an interest-rate increase in 2000 and tax increases in 1997 that were premature. A financial crisis, which Japan was supposed to have dispelled, is again stalking the economy in 2003. Deflation in the consumer price index (CPI) increases the real interest rate despite the zero (nominal) interest rate policy, and asset prices continue to decline. Japan is on the verge of, if not already in, a deflationary spiral. One possible way out of this stagnation is a depreciation of the yen, either market-driven or intervention-driven. The yen depreciation would work on the real side and the nominal side. Depreciation would stimulate export industries and profits would trickle down to salaries and wages in those sectors. Consumption would increase. Depreciation also would help stop the CPI deflation. Some economists—Svensson in particular—have called for an explicit depreciation policy backed by price-level targeting. This paper will investigate, first, the reasons for the failure of market forces to depreciate the yen despite Japan's weak economic performance; second, how large a depreciation would be required to effectively contribute to recovery; third, whether depreciation-led recovery of Japan can increase imports from Asia and the United States as well as exports to the world; and fourth, the feasibility of a depreciation policy.

Rishi Goyal, International Monetary Fund, and Ronald McKinnon, Stanford University, "International Creditors under the World Dollar Standard: Japan's Liquidity Trap Redux"

In any creditor economy with a history of current-account surpluses, the buildup of foreign currency claims could lead to deflation and a zero-interest rate liquidity trap if that country is threatened with continual appreciation of its currency. Japan is the most obvious case, but foreign pressure on China to appreciate the renminbi is intense. We will develop a theoretical model of how this foreign exchange impasse undermines the ability of the domestic monetary authorities to prevent deflation, and then illustrate with data drawn from both the Japanese and Chinese experiences.

Mitushiro Fukao, Keio University, "The Effects of 'Gesell' (Currency) Taxes in Promoting Japan's Economic Recovery"

The Japanese economy has been experiencing accelerating deflation since the mid-1990s. By the end of 2003, the GDP deflator has fallen by about 10 percent from a peak in 1994 and has continued to fall at an annual rate of more than 2 percent. Even though nominal interest rates are extremely low, real interest rates are rising and conventional monetary policy has lost its effectiveness. Given the explosive rise of government debts, fiscal policy is also facing a severe constraint. In order to stop deflation without destroying the creditworthiness of the Japanese government, this paper will investigate the introduction of a tax on money and near-money balances. The proposal is for the Japanese Government to levy a 2-3 percent tax on the balances of all yen-denominated financial assets whose value is guaranteed by the government. Taxable assets include cash, guaranteed deposits, government bonds, and other assets. The tax rate should be slightly higher than the rate of deflation, and the tax should be levied repeatedly as long as the deflation continues. This tax is similar to the famous Silvio Gesell's stamp-duty on currency described by Keynes in Chapter 23 in his 1936 *General Theory*. The Gesell tax will effectively allow the monetary authority to achieve negative nominal interest rates on safe assets.

C. International Transmission and Coordination of Macro/Financial Policies

Koichiro Kamada and Izumi Takagawa, Bank of Japan, "Monetary Cooperation in East Asia and Across the Pacific"

The deepening interdependence in the Asia-Pacific region was not only a foundation for the East Asian Miracle, but also a trigger for a chain reaction of economic bankruptcy during the Asian Currency Crisis. This paper will present a macro-econometric model that captures the strong economic interdependence and divergent stances of currency policy observed in the Asia-Pacific region and a discussion based on model simulations of the consequences of various forms of monetary co-operation in this region. The emphasis will be on the evaluation of the currency regime to date and the currency-basket system as a stabilization policy for East Asia and on the implications for Japanese monetary policy in the context of the zero bound of interest rates.

Koichi Hamada, Yale University, and Asahi Noguchi, Senshu University, "The Role of Economic Perception vs. the Role of Group Interests in Macroeconomic Policies"

"Liberal" international political economy emphasizes the effects of national interests and the domestic conflict of interests. On the other hand, economists such as Frankel argue that the difference of perception on open-economy macroeconomic policies matters significantly. This debate goes back to Buchanan (Stigler), who developed the political economy approach to vested interests, and to Keynes who emphasized the role of ideas. We will examine this issue using the experience of international monetary coordination in the late 1950s, the gold standard restoration debate in the 1920s, and the debate of policies against deflation in the more recent period.