

Monetary Policy Navigating through a Narrow Path: Between the Subprime Problems and the Oil-Commodity Inflation.

To the ESRI-NBER Meeting, June 2008.

Please distribute to participants the following (abridged) translation of my article on the Nikkei about Japan's monetary policy, June 17, 2008.

Koichi Hamada (Yale University)

This note discusses the perspective for the policy of the Bank of Japan (BOJ) under the new Governor, Masaaki Shirakawa, particularly in view of the unfortunate policy experience during the 1990s.

The BOJ faces the difficult task of maneuvering its policy narrowly between the worry of financial disorder triggered by the subprime problems and the risk of allowing inflation in food and oil prices. The low interest rate policy by the Federal Reserve does not provide the fundamental solution to the subprime problem, but only serves as a stop gap therapy. It is needed, unfortunately, as a means to prevent a systemic collapse of the financial system.

On the other hand, if Japan and other countries encounter the impact of the weaker dollar arising from the U. S. expansionary policy, then these competitive devaluation processes may end up fueling the momentum for the world-wide commodity inflation, particularly, in petroleum. In this sense, Japan's monetary policy, as well as that of other countries, is quite likely to be led into an impasse.

It is instructive to compare the process of FRB's reduction of interest rates after the outset of subprime problems, with the monetary policy of Japan during the 1990s. During the years 1992-93, two years passed after the first crash of stock market at the beginning of the decade, when land prices were beginning to fall, the BOJ kept contracting its monetary policy. Figure 1 shows a precipitous decline of money supply during the period.

I regard this monetary contraction as one of the major causes for Japan's lost decade. Due to this abrupt contraction policy, asset prices fell dramatically, chains of intermediation in the Japanese economy were broken. Asset prices

depend on the fundamentals and their prospects, but they are strongly affected by the supply of alternative assets including money. Even if the inflated prices had been the results of bubbles, those prices were guiding agents' behavior. Too hasty corrections interrupted normal economic mechanisms. Consider a salary-man who built a house by mortgage, and who was left with lost land-house prices and still had liabilities with unchanging values. Lenders of fixed value securities, who could have gained by deflation, could not collect the non-performing loans.

The initial intent of busting the bubbles might have been justified, but since it was executed with such severity, the consequences were a sudden decline in asset prices, outset of deflation and the appearance of the liquidity trap that incapacitated the effectiveness of monetary policy.

This can be also illustrated by the movement of real effective exchange rate in Figure 2. The real effective exchange rate is an overall (counting all the trade partners) index of the purchasing power of the yen, or more precisely, the purchasing power of the Japanese GDP product.

When the REER is higher, export industries have to compete harder in the foreign market because their products lose international competitiveness.* Though a higher REER benefits Japanese consumers, it is a hardship for import competitors. Dale Jorgenson and Koji Nomura estimate the real exchange rate of yen in terms of US and Japanese real exchange rate relative to dollar was appreciated by 78 percent from the moment of the Plaza Accord.

Thus the combination of the exchange rate policy by the Ministry of Finance (MOF) and the monetary policy of the BOJ, which often preferred the direction of a higher yen, imposed upon the Japanese industry a higher handicap or hurdle. This hurdle had to be overcome by productivity increases and reduction of prices in the Japanese industry.

It is reported that the REER of the yen returned to the level before the Plaza Accord. Since it is estimated that the REER before the Plaza left some competitive edge for Japanese industry, the report indicates luckily that the Japanese industry still has some capacity for a higher nominal level of the yen.

The BOJ introduced the “zero interest policy” that realized exactly the liquidity

trap. Under this situation, money and short term government securities became almost a perfect substitute so that the purchasing operation, that is, the exchange of these two assets was rendered ineffective. Therefore the operation should have targeted less substitutable assets, for example, the dollar denominated assets.

This is the reason that Larry Svensson and others advocated the intervention in the exchange market, often combined with the inflation or price level target, as the effective way to salvage the Japanese economy from the liquidity trap. It is my regret that I did not emphasize the role of the exchange intervention in the zero interest economy in my tenure as the head of the ESRI.

Intervention during 2003-4, conducted under Zenbei Mizoguchi as Vice Minister of Finance, and named later by John Taylor as “Great Intervention,” was instrumental in resisting the trend of the yen for appreciating under the U. S. low interest rate. This policy facilitated the gradual reduction of the REER of the yen and promoted the recovery of the Japanese economy. Toshihiko Fukui, then Governor of the BOJ, should be commended for refraining from comments or policy actions that would weaken the effectiveness of the great intervention.

With the loss of the majority by the Liberal Democratic Party (LDP), the Democratic Party (DP) obtained a casting vote position on certain issues like the appointment of the Governor and Deputy Governors of the BOJ. It is in itself a healthy direction in the maturing process of democracy. Partly due to the misunderstanding of the DP, it ended with the rejection of candidates including the world known Takatoshi Ito. It is a pity for the Japanese economic policy, just as it was unfortunate that the autonomy of the BOJ, which was intrinsically an improvement, was employed to implement the untimely departure from the zero interest policy.

The appointment of the Governor or Governors of the BOJ should be chosen by their merits, and not be determined as a destination seat of the parachuting of MOF officials, nor as the means of party politics. Economists should make effort to keep enlightening party leaders.

The resulting two members of the top BOJ officials, Masaaki Shirakawa as the Governor and Kiyohiko Nishimura as a Deputy Governor are excellent choices, Masaaki Shirakawa published a large volume of *Modern Monetary Policy*, which

explains brilliantly the policy mechanism in the BOJ. I learned a lot from this book that is written meticulously with reference to contemporary monetary policies.

I may have to refrain from commenting on his book as an academic because his role has changed. Lest his views are mystified as those of Pope, I cannot help mentioning a few points.

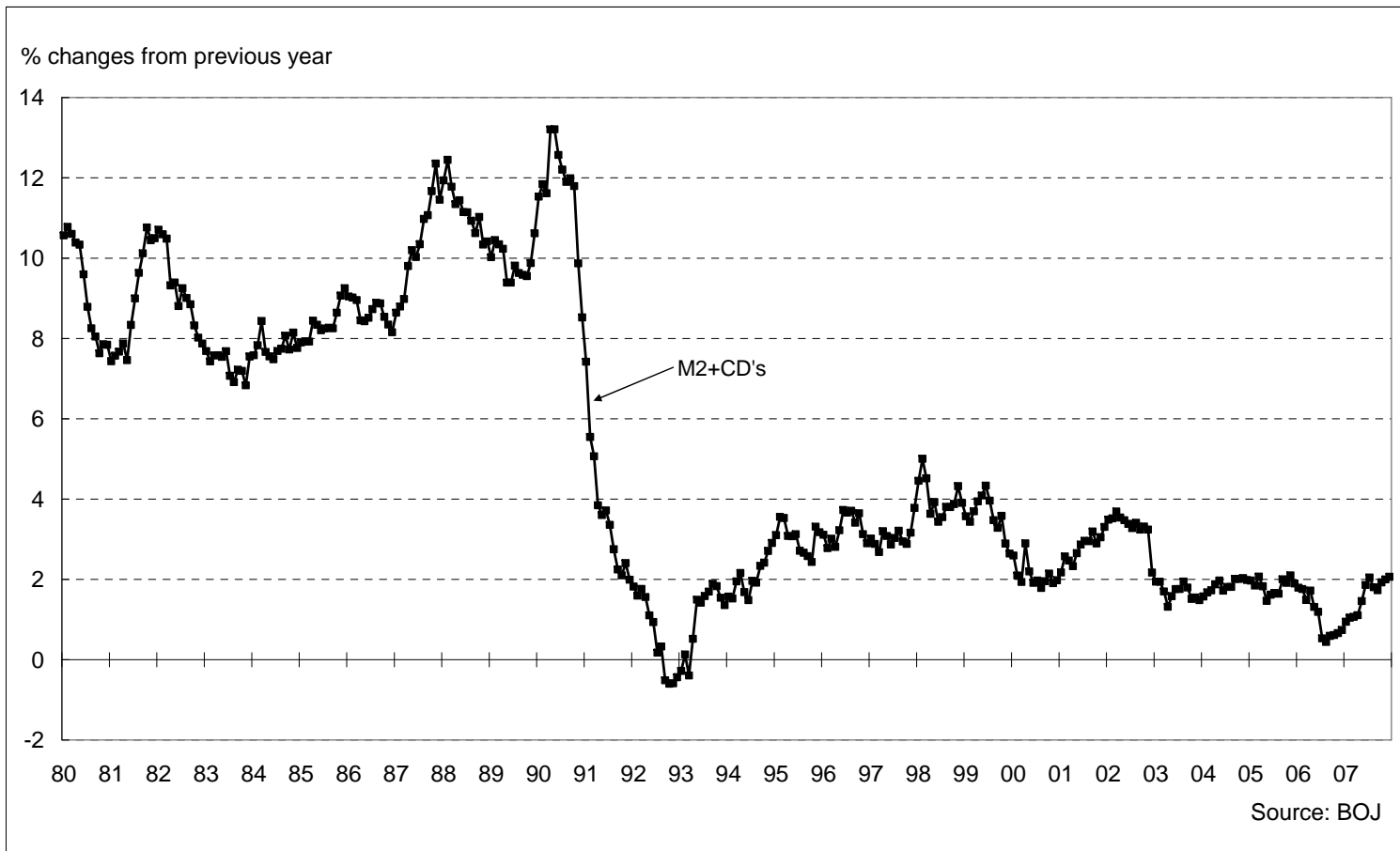
First, since the book is intended to explain the BOJ policy and its environment, it falls short of examining the transmission process of the monetary policy to national economic activity. It does not explain enough how the sudden collapse of asset prices, which are at least partly triggered by the monetary policy, generated the massive non-performing assets, credit crunches, zombie lending. Just as the book describes well how water flows within or near the garden of the BOJ, it does not pay enough attention to the way the monetary policy affects the life of people.

Second, it does not take into account seriously enough the way the monetary policy affects the international performance of the Japanese economy, for example, through exchange rates as we described in this short essay.

Third, though the book mentions modern literature, it does it rather selectively by avoiding literature that contains serious criticisms of the BOJ policy. For example, it pays some of the most relevant BOJ policy only little attention, for example, the work of Svensson and Takatoshi Ito. The Bank of Japan invites many distinguished scholars from all over the world, but some of the contributed papers with important policy implications were neglected in the large list of reference in the Governor's book.

I welcome the birth of a new Governor who has an outstanding intellectual level. If Masaaki Shirakawa exerts little effort to defend the past policy of the BOJ, if he pays attention to both possible downward as well as upward swings of business cycle, and if he conducts his policy with sufficient macroeconomic as well as international perspective, then it may not be a dream that he will make a central bank governor who will be remembered by history.

Figure 1: Growth Rate of Money Stock (M2+CD's)



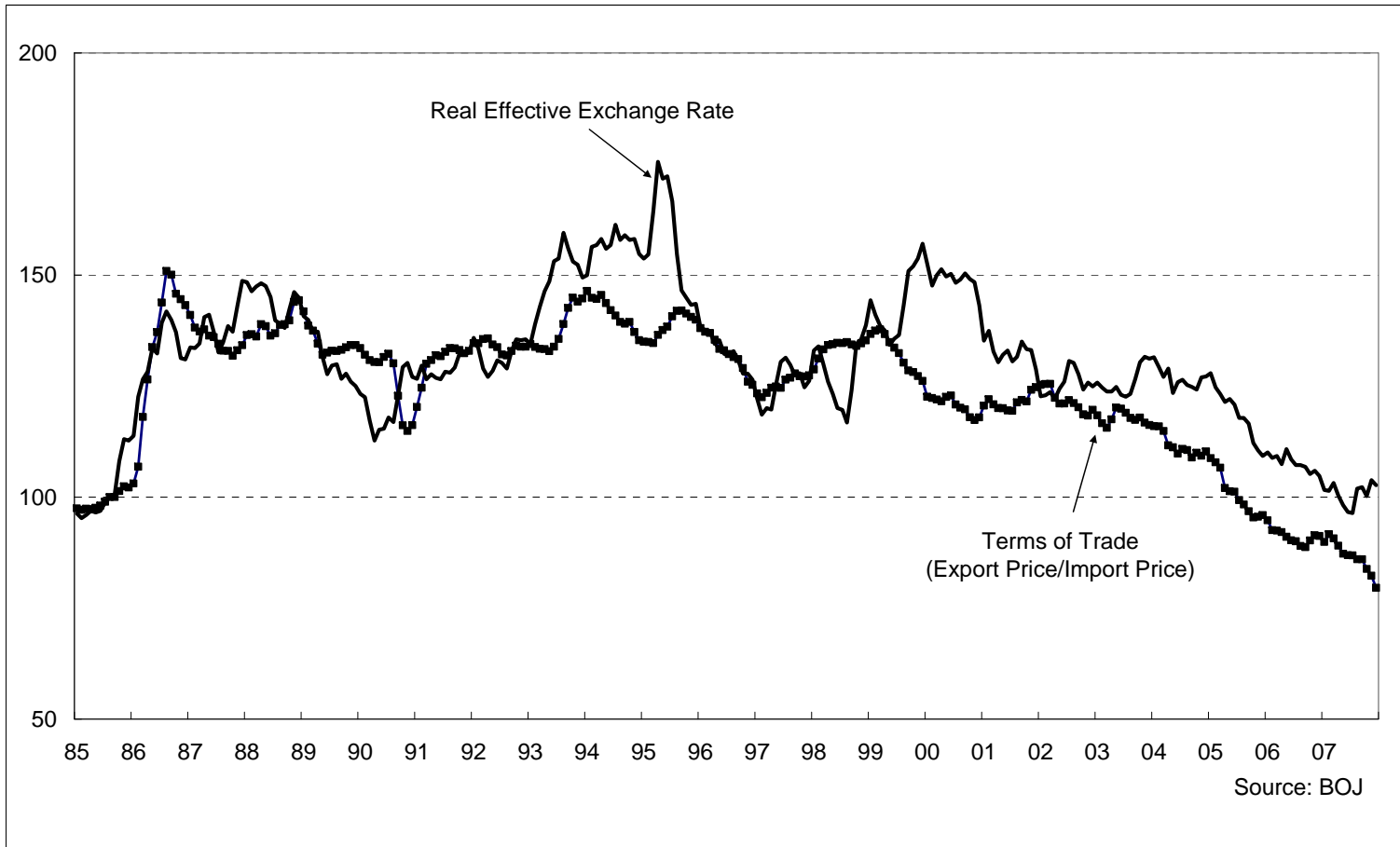


Figure 1: Real Effective Exchange Rate of Yen and Terms of Trade