Japanese Macroeconomic Policy Management after the Global Financial Crisis[1]

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Abstract

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

I. Introduction

The financial crisis that started in the US housing market triggered an unprecedented deterioration of the global economic condition in late 2008 and the first half of 2009. Japan, along with other East Asian countries, had been relatively distant 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 the 2000s. Japanese economy stepped on its emergency brake in the fourth quarter of 2008 and the first quarter of 2009, resulting in an average negative GDP growth of less than −10.0% in the annual rate for this six month period.

Responding to the global economic crisis, major countries lowered their interest rates and took fiscal measures, as well as microeconomic policy responses, to preserve their financial systems and financial institutions. In this note, instead of describing Japan's macroeconomic policies in detail, I compare Japan's economic situation and its policy responses with those of European countries and the United States. I believe this strategy is more effective for two reasons. First, developed countries face more or less similar problems: deteriorating fiscal

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conditions and zero bound interest rates are common constraints to their macroeconomic policies. Comparison 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 about economic policies, to understand their different conduct in terms of macro economic responses. Making comparison with other countries is the easiest way to do this.

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

II. Macroeconomic Policy Responses in the United States and Europe

II.1. The United States

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

However, to understand the 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 that it still has such a large influence on academia and policy makers in 21st century. While there is a sharp rivalry regarding 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 a milestone in economic analysis of the Great Depression. In this book, Friedman and Schwartz emphasize the death of the NY FED chairman, Benjamin Strong, and the resulting lack of strong leadership within the Federal Reserve System in facing the financial panics in the early 1930s as the main causes of the Great Depression. Even though some people disagree with Friedman and Schwartz about the importance of the NY FED chairman's death, there is a broad and solid consensus about their main point that the failure of the FED's monetary policy was the biggest cause of prolonged depression in the United States in the interwar period.

The subsequent academic literature basically complements, rather than replaces, the main themes of Friedman and Schwartz. The seminal article by Bernanke (1983) emphasizes the wave of banking crises and the breakdown of financial intermediation which caused a significant decline in US money multipliers in the first three years of the 1930s. Eichengreen and Sachs (1985) and particularly Eichengreen (1992) emphasized the international dimension of the Great Depression. The "Golden Fetters" - the central bank's obsession with the gold standard - is singled out by Eichengreen and his coauthors as an important reason for the muted monetary policy responses to the banking panic in the 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 so difficult to understand why today's FED led by Bernanke has responded aggressively to the current global financial crisis. While the FED faces some criticism and possible mini-bubbles in commodity markets because of loose monetary policy, the FED is so afraid of a possible double dip recession that an "exit" policy taken too early might cause. If there is any bias in FED's policy, it has to be over expansionary rather than over contractionary.

II.2. Europe

It was not easy to grasp what was going on in Europe from the Far East, since the coverage by both media and researchers on this area is much more limited compared with that about the US economy. However, we have learned about the European situation and their problems over time. First, European financial institutions were much more extensively and directly involved in the US sub-prime loan problem than we (i.e., as Japanese and East Asian observers) thought. Second, European countries have their own problems and they are as serious as US problems: such as the collapse 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, the top priority seems to be the credibility of the Euro. Hence, fiscal discipline and low inflation are the backbone of macroeconomic policies for attaining this ultimate goal.

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

At this point, it is difficult to judge whether the conservative European option or the aggressive American option will yield higher returns for those countries in the long-run. There is no obvious answer to attaining a balance between higher current economic growth and reconstructing the fiscal situation. It is a difficult problem for both Europeans and the United States, as well as for Japan. One thing that is obvious in the near future is that, if all other things are equal, the European exit from its emergency policy regime will be earlier than that of the United States.

III. Japanese Macroeconomic Policies

The Japanese economy also faces a similar set of macroeconomic difficulties: a high debt-GDP ratio and extremely low interest rates. On the surface, the Japanese problems are the worst among the developed economies: its debt-GDP ratio is the highest and its 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 a significant current account surplus and close to 95% of its government debts are held by domestic investors. This is good news for the Japanese economy in the short-run, because the potential for a debt crisis is still remote, despite an extremely high level of debt outstanding. This is bad news in the long-run, because the Japanese are basically transferring their burden to future generations.

III.1. Fiscal Policy Response to the Global Financial Crisis

To fight deflationary pressure and sharply declining exports, the 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. The 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, to ensure “emergency economy-boosting measures for a secure and growing future economy.” The national budget for FY2010, which was 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 that of any other major countries. It will take some time to properly assess the effectiveness of its fiscal policy in 2009 and 2010 quantitatively. While the fiscal measures such as the subsidies for the purchase of energy conserving home appliances (the so-called *Eco-point System*) have definitely contributed to boosting the economy, it has been argued that the repeated fiscal stimuli and accumulating government debt since the late 1990s have significantly lowered the Japanese fiscal multiplier. On the other hand, in November 2009, the Japanese government and the Bank of Japan declared that they recognize deflation as the serious obstacle to the economy. Hence, it is difficult to claim that the Japanese economy is now surely on a self-sustaining path of recovery.

III.2. Japan's Fiscal Problem

As an unavoidable side-effect of these aggressive economic stimulus policies, the Japanese budget deficit relative to GDP is soaring. Once again Japan's long-run fiscal sustainability has become the focus of attention among policy makers, academics, and investors, as well as the general public. The 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, the Hatoyama administration introduced the public reviewers' budget screening operation (the so-called *Jigyo-shiwake*). Admittedly, there have been important and relevant criticisms from various parties about how the screening operation is conducted. However, the new budget screening operation has definitely improved the transparency of the budgeting process and the general public's support is strong. The new administration also declared its promotion of policies to increase long-run economic growth, in areas such as children and educational support, and the 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, there are many government businesses, projects, and programs that will face budget cuts from the restructuring of government expenditure. Behind them, there are private businesses so dependent on government-related business that they cannot survive without it. 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 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, government budget policy is neutral for macro economic performance. However, more realistically, there are at least some myopic or liquidity constrained households (as known as "Keynesian consumers") in the economy. As a result, fiscal reconstruction will definitely have negative impact on macroeconomic performance in the short-run.

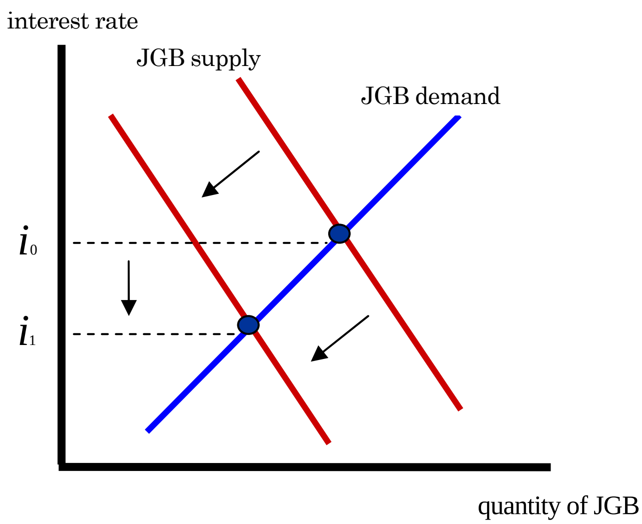
On the other hand, there are a number of studies which, based on the experience of

European countries, argue that fiscal reconstruction can be expansionary. Such a possibility is called a "non-Keynesian effect" of fiscal expenditure. There are two primary channels by which the reduction of government debt indeed stimulates aggregate output. The first channel is through lower interest rates. Large government debt is typically associated with high risk premiums on sovereign debt, and so higher interest rates. Credible commitment to fiscal reconstruction can significantly lower the interest rates by reducing the risk premium on government bonds (Figure 1, Panel A). Lower interest rates stimulate business investment in the private sector and thus boost the real economy.

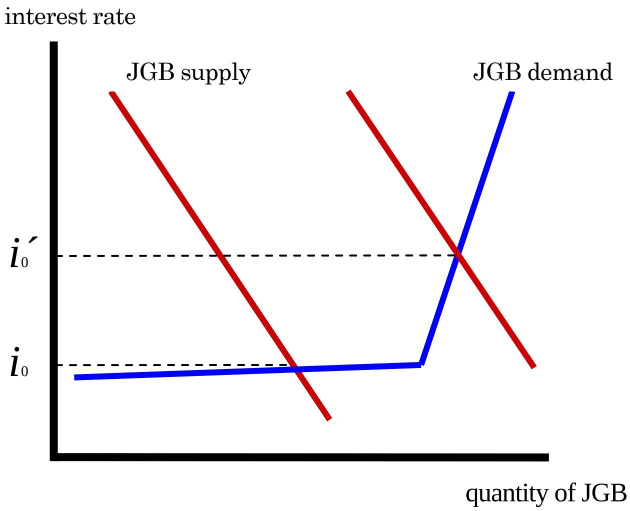
However, such an "interest rate" channel is unlikely to work in the Japanese case, because the Japanese interest rate has been and will probably remain at an extremely low level. This is because of the Japanese economic environment as described at the beginning of this section. Unlike Western countries, Japan is still running a significant current account surplus and the 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. In any case, there are two groups of investors in the JGB market. The first group 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). The current JGB interest rate (i_0) is too low for the majority of foreign investors. Without such affluent domestic demand for JGB, the Japanese interest rate would have had to be much higher like (i_0') in Panel B, so that recession would have been even worse. In this sense, Japan has already used up its potential for non-Keynesian effects through the interest rate channel.

Figure 1: Non-Keynesian Effect of Fiscal Restructuring through Interest Rate Channel

A. How a Non-Keynesian Effect is supposed to work



B. Current Japanese situation



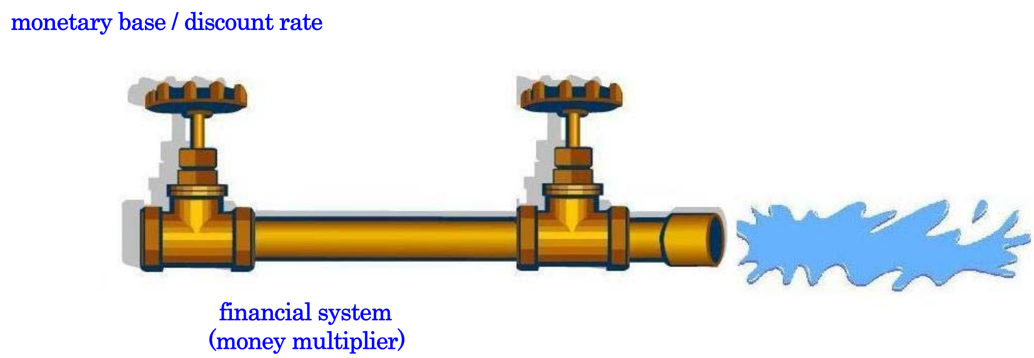
The second possible channel of non-Keynesian effects is the improvement of the efficiency of government spending by reducing unnecessary government projects. Perhaps, this is the only possibility by which fiscal reconstruction in Japan would stimulate macro economic performance. However, as we discussed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

III.3. Monetary Policy

Another important limit on Japanese macroeconomic policy is the ineffectiveness of monetary policy due to the zero bound interest rate. In the conventional framework of Keynesian IS-LM analysis, monetary policy works by lowering the interest rate or the increasing monetary base which will cause an 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 a proportional increase of money supply by increasing the monetary base, the financial intermediaries such as commercial banks must be functioning properly. In an abstract expression, this means that the stability of the money multiplier is necessary for effective monetary policy management, as in the IS-LM analysis. As demonstrated in Bernanke (1983) a banking panic will generate a breakdown of the financial intermediation function in the economy and make the money multiplier significantly lower and unstable (Figure 3).

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

Figure 3: Monetary Policy in a More Realistic Framework

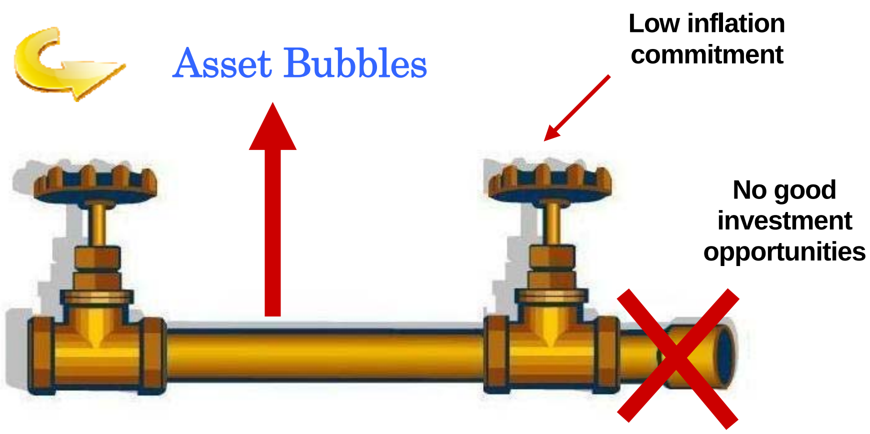


Discussions similar to the above discussion can be found in standard textbooks in macroeconomics or monetary economics (e.g. Abel, Bernanke and Croushor 2007; Hubbard 2007). However, when the short-term interest rate hits the zero lower bound, conventional monetary policy will not work. As unconventional monetary policy measures in such an environment, monetary policy regimes such as quantitative easing and inflation targeting have been discussed extensively, and implemented to some extent. The effectiveness of such unconventional policies is an important topic, but it is beyond the focus of this paper. Instead, in the following, I will briefly discuss the implications of recent monetary policy debates and the experiences of the Japanese economy and the US economy.

Since the high inflation period of the 1970s, fighting inflation became a top priority of the central banks of developed economies around the world. By the late 1980s, most of them achieved this goal and enjoyed the subsequent period, called the “Great Moderation”, until several years ago. The Great Moderation has been often attributed to “improved” policy management by central banks, but by now it has become obvious that there are important adverse side effects with the central banks’ monetary policy regime in this period. Both the Japanese asset price bubble in the late 1980s and the US subprime loan problem were preceded by a period of loose monetary policy and low inflation rates. More specifically, the Bank of Japan after Plaza Accord of 1985, loosened monetary policy while committing strongly to low inflation rates, to accommodate the negative impact of the sharp appreciation of the Yen’s exchange rate. Alan Greenspan similarly cut the US short-term rate in a drastic manner after the collapse of the 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 rates created speculation in the asset markets in both cases. In retrospect, it was the wealth effects of asset bubbles that contributed to the sustained growth of the real side of the economy.

Policy makers’ intention had been to find a balance between low inflation and strong economic growth. However, it turned out that pursuing this goal tends to generate speculative movements in asset markets. Monetary authorities around the world learned the lesson the hard way that they have to consider the trilateral balance among inflation, real economic growth, and financial euphoria in asset markets at the same time (Figure 4).

Figure 4: Monetary Policy and Asset Bubbles



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 since as early as the first half of the 1980s. So lowering the interest rate created a 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 the real estate market. Bernanke's FED seems to be facing the similar problem. Although the 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 responded yet. Meanwhile, since the summer of 2009, speculative money has started to play with commodity markets once again. The FED's dilemma is whether to tighten monetary policy to curb further speculation or to keep pumping money into the financial system to avoid potential double dip recession. Overall, it is not so obvious 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 would be the best practical solution for central banks to deal with such a trilateral balance problem? The current response by the Bank of Japan seems to be putting more weight on low inflation and the avoidance of speculation, rather than on economic growth. The US Federal Reserve seems to be exploring real economic growth more aggressively, while exploring the use of some other microeconomic measures to directly curb excessive risk taking by financial institutions. However, in all regards, it is too early to judge if the FED's attempt will succeed or not.

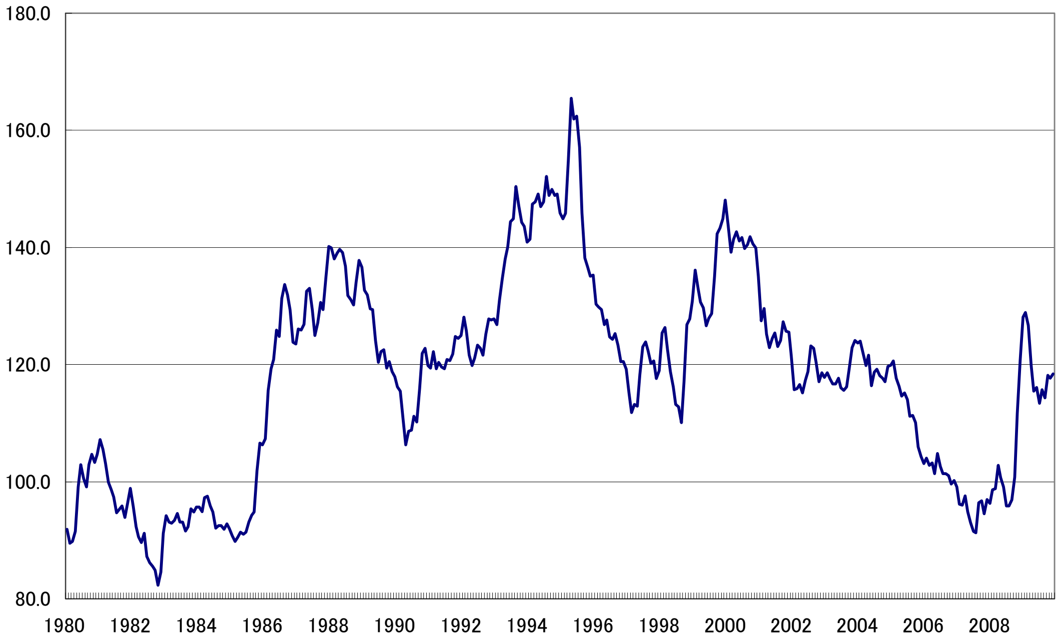
A related third question is that, given that we use direct microeconomic regulations to fight speculation in asset markets, who is the best authority to be responsible for such policy measures? One opinion in current discussion on US financial regulatory reform is that it should be the FED since it is difficult for the regulatory bodies like SEC to make short-term economic judgments, such as whether a "bubble" component in current asset prices is too large. However, it is also true that the FED was largely responsible for creating the financial euphoria in the sub-prime loan problem. There are many economists and politicians who are critical of the FED about this point, and so oppose giving the FED such authority.

IV. Conclusions

This note has analyzed current Japanese macroeconomic environment and policy challenges from a comparative perspective. Let me conclude it by discussing the timing of an "exit" from the emergency policy regimes in Europe, Japan, and in the United States.

As discussed above, if all other things are equal, Europe will prefer to exit from its current policy regime as soon as possible. Hence, it is most likely that the ECB will increase its interest rate prior to the FED. The Bank of Japan, on the other hand, has relatively limited choices. In 2006, when the BOJ stopped its quantitative easing regime in monetary policy, the real exchange rate of the Yen was at a level as low as right before the Plaza Accord in 1985 and foreign export demand was booming (Figure 5). The Yen has bounced back and external demand has plunged into a trough in late 2008 to early 2009. As long as the FED keeps the US rate low and puts downward pressure on the value of the US dollar, the Bank of Japan probably have to dance with it, unless its domestic economy miraculously revamps and recovers.

Figure 5: Real Effective Rate of Japanese Yen: January 1980 - November 2009



However, there are too may uncertainties in this scenario. The European troubles seem to be getting worse. It is possible the United States will recover first, by keeping its loose monetary policy and lowering its currency to help adjustment. Although, more unlikely, it is also possible that Japan will recover even faster if Asian emerging economies continue to recover and grow, so that Japan’s exports to those country accelerates. However, the biggest uncertainty right now for the Japanese economy is whether the Chinese economy will continue to grow at the current speed. It is difficult to imagine that China will completely fall back to the level of an underdeveloped economy, but many expect that some large adjustment is unavoidable. How large the adjustment will be and the effects it will have on the Japanese economy are of major concerns for Japan and of other East Asian countries.

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