Japanese Economic Recovery and the Macroeconomic Policy Mix

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I. Introduction

There is much cheer surrounding the Japanese economy finally reaching the end of the long and painful path of post bubble adjustments. As the signs of economic recovery spread from manufacturing to non-manufacturing industries, from large to small firms, and from metropolitan to regional areas, the economy is gaining momentum towards restoration of sustained growth. In 2003, the economy registered a real GDP growth of 2.7 percent, which is more than 100 basis point higher than the average growth of real output during 1991-2000. Business investment recorded a strong growth of 9.6 percent in 2003 close to the peak recorded in 2000, the IT boom year. Growth in industrial production turned around from a negative growth of 9.1 percent in 2001 to a positive growth of 3.5 percent in 2003. The rise in unemployment has been arrested; the unemployment rate fell slightly from 5.8 percent in 2002 to 5.7 percent in 2003 and is expected to come down to 4.7 percent in 2004. On the demand side, both growth in external demand and domestic demand have grown at a moderate but positive pace, 0.9 percent and 2.4 percent, respectively during 2003. With the revival of domestic consumption growth in the current year, it is expected that the projected growth of 4.3 percent for real output in 2004 would be realized.

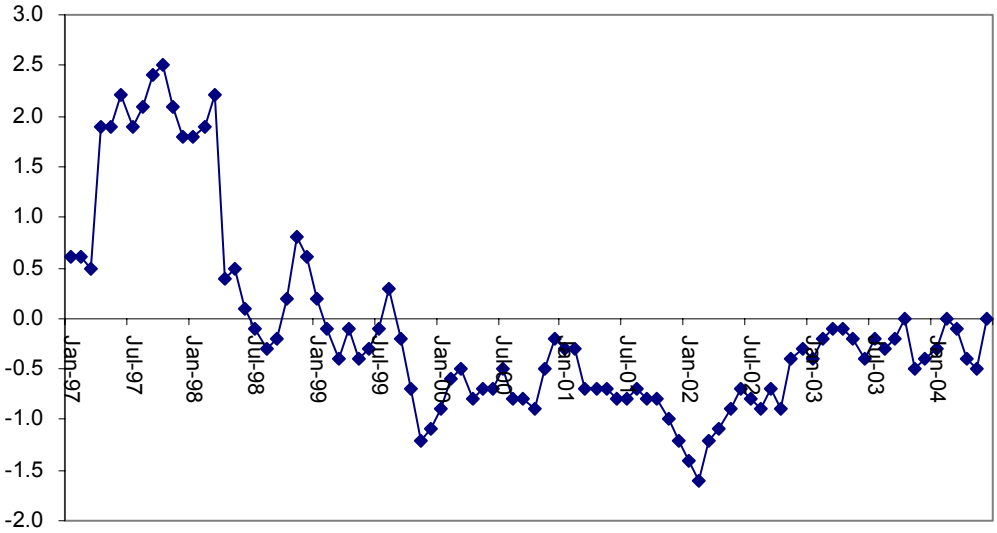
While the turnaround in real economic indices has generated the confidence to pronounce the present spurt in economic activity as the beginning of a sustained economic recovery, the behaviour of prices continues to be a source of concern. Even as recently as May 2004, Japan's CPI fell by 0.5 per cent from a year ago. Prices of commodities have witnessed steady declines since 1998 resulting in more than five years of near continuous fall in overall price levels in the economy. With marked increase in world oil prices, prices of raw materials and intermediate goods have started to pick up. This is reflected in the rise in corporate goods price index (CGPI) in the recent months. The cost-push inflation has however not cascaded onto the prices of final goods. Also land prices – commercial, residential, and industrial – continue to decline.

The importance of inflation in the present context can hardly be overstated. Inflation would redistribute purchasing power from the creditors to the debtors within the economy. Inflation would ease the intense pressure of repayment on debtors, specifically, and on the financial system, more generally. Since the early 1990s, borrowers in Japan have repeatedly found themselves squeezed by deflation that has required them to pay their debts in yen of greater value than they had expected. Borrower distress has affected the functioning of the whole economy by weakening the banking system and depressing investment spending. A general inflation would exert a positive pressure on asset prices and thereby improve the balance sheet position of the debtors. Inflation would also provide a boost to corporate profits and provide a spurt to investment, economic activity

and employment in the economy. In recent statements, Governor, Toshihiko Fuku, has repeatedly stressed that the Bank of Japan will maintain its ultra-loose monetary policy until the year-on-year change in the core nationwide consumer price index remains at or above zero for a prolonged period. There is growing recognition that it would still be sometime before prices started to rise even when the strong momentum of the economy's recovery spreads. Prices have proved to be the Achilles heel of the Japanese economy in the recent times.

FIGURE 1

Monthly Change in Consumer Price Index of Japan: 1:1997 to 6: 2004



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, Japan. [*http://www.stat.go.jp/english/index.htm*](http://www.stat.go.jp/english/index.htm)

Several observers have compared the recent Japanese deflation to the Great Depression of the early 1930s, when there was a massive contraction in real output, unemployment and the prices declined. Surely, there isn't sufficient basis for such a comparison in terms of the quantitative score. In the background of the high and enduring growth performance of the previous several decades in Japan, the decline in output, employment and prices have indeed been severe. Even so, the magnitudes are nowhere comparable to the enormous declines witnessed during the Great Depression. During the major contraction phase of the Great Depression, between 1929 and 1933, prices fell at a rate of nearly 10 percent per year. Whereas even in the worst years, 2001 and 2002, the consumer price index in Japan has fallen by just over one percent. (see Figure 1 and Table 1 below) Since the onset of the current deflationary episode - the price level has registered a cumulative decline of between 4 and 9 percent depending on the price index. Over the five year period ending May 2003 the GDP deflator dropped nearly 9 percent, the private consumption deflator fell by 5.5 percent, and wages and salaries were down 4.5 percent.

Real output in the United States during 1929 to 1933, fell nearly 30 percent and the unemployment rate rose from about 3 percent to nearly 25 percent. Whereas in Japan the growth of real output has been positive in most of the years and the output gap measuring the difference between the actual and the potential output is in the range of 1-3 percent (annual). The unemployment rate in Japan rose from around 2 percent in 1990 where it had stayed for close to two decades to above 5 percent by the year 2002. Thus, the Japanese depression is much milder in intensity when compared to the Great Depression.

However, the context of Great Depression might well be evoked for the powerful policy mechanisms it had established. And the experiences of these years can be very relevant to view the present policies of the Japanese authorities in responding to the economic crisis.

The Great depression and the following years of recovery were instrumental in breaking with the orthodoxy of economic thought and giving a new orientation to macroeconomic policy that accorded government intervention a central role in combating depression. *Public expenditure through deficit spending* was suggested as the necessary means to boost effective demand during economic slump. To quote from John Maynard Keynes writings on the technique of recovery,

`As the prime mover in the first stage of the technique of recovery I lay overwhelming emphasis on the increase of national purchasing power resulting from *governmental expenditure which is financed by Loans and not by taxing present incomes*. Nothing else counts in comparison with this. In a boom inflation can be caused by allowing unlimited credit to support the excited enthusiasm of business speculators. But in a slump governmental Loan expenditure is the only sure means of securing quickly a rising output at rising prices. That is why a war has always caused intense industrial activity. In the past orthodox finance has regarded a war as the only legitimate excuse for creating employment by governmental expenditure. You, Mr President, having cast off such fetters, are free to engage in the interests of peace and prosperity the technique which hitherto has only been allowed to serve the purposes of war and destruction.'
An Open Letter to President Roosevelt by J. M. Keynes, 1933. [1]

The effectiveness of monetary policy with the economic indicators already signaling low interest rates and declining prices, as in the recent Japanese slump, was clearly doubted by Keynes though Keynes never described the inter-war US economy as stuck in a liquidity trap, the extreme case where the Central Bank attempts at lowering interest rate through monetary expansion are completely defeated because of the perfectly elastic demand for money at the prevailing rate of interest. Commenting on the flawed implications of the Quantity Theory of Money for depression economies, Keynes wrote,

`The other set of fallacies, of which I fear the influence, arises out of a crude economic doctrine commonly known as the Quantity Theory of Money. Rising output and rising incomes will suffer a set-back sooner or later if the quantity of money is rigidly fixed. Some people seem to infer from this that output and income can be raised by increasing the quantity of money. But this is like trying to get fat by buying a larger belt. In the United States today your belt is plenty big enough for your belly. It is a most misleading thing to stress the quantity of money, which is only a limiting factor, rather than the volume of expenditure, which is the operative factor.'
An Open Letter to President Roosevelt by J. M. Keynes, 1933.

[1] John Maynard Keynes, An Open Letter to President Roosevelt, New York Times, December 16, 1933 http://newdeal.feri.org/misc/keynes2.htm

Just as the role of monetary and fiscal policy for aggregate demand push was redefined by Keynes, the General Theory of Employment, Money and Interest (J.M. Keynes,1936) provided new ways of understanding the modern stock-market based financial system. As in the Japanese case where the economic slump followed the stock market collapse and a burst in asset price bubble, the Great Depression had followed the stock market crash of 1929. From the beginning Keynes was extremely skeptical about the role of stock markets in determining private investment and feared that `as the organization of investment markets improves the risk of predominance of speculation would increase'. Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. Keynes predicted that `when the capital development of a country becomes a by-product of the activities of a casino the job is likely to be ill-done.' (Keynes, 1936; pp. 159)

Accordingly, the recovery from the Great Depression in the United States was engineered under President Roosevelt's leadership through vast and multi-faceted programmes of the New Deal (1933-35). A series of government agencies were set up to reorganize industry and agriculture under controls and to revive the economy by a vast expenditure of public funds. Finance and banking were regulated by new laws that loosened credit and insured deposits and the United States went off the gold standard. Later on came more reform legislation and new government agencies were set up. The Securities and Exchange Commission was set up to regulate banks and stock exchanges. The Work Projects Administration was intended to offer immediate work programs for the unemployed, while the legislation for social security was a long-range plan for the future protection of the worker in unemployment, sickness, and old age. In the following years the US economy not only recovered from the slump but during 1940-45 achieved some of the highest ever growth rates.

The present paper reviews the macroeconomic policy mix of the Japanese economy during the 1990s specifically in reference to the three crucial sectors of fiscal policy, monetary policy and financial policies that Keynes had emphasized. In critically analyzing these policies our attempt would be to see in what ways these policies have contributed to the process of economic recovery.

The outline of the paper is as follows. The next two sections (Section II and III) discuss the Japanese financial policy, fiscal policy and monetary policy during the 1990s. We find that the financial sector has undergone a radical shift towards neo-liberal market driven objectives and structures so that the objective of allocative efficiency in the economy has given way to operational efficiency for each financial institution. This has slowed the process of economic recovery. The macroeconomic policy mix suggests an overall conservative monetarist format within which Keynesian pump priming has been accommodated somewhat uneasily. And lately, even the meager fiscal push has been reversed. Section IV takes a closer look at the Bank of Japan monetary policy and the controversies and dissatisfaction surrounding its role in economic recovery. The disappointment primarily springs from the failure to prevent deflation and effect a rise in price level through monetary policy management. We argue that the attack on monetary

authorities is misplaced since the present situation in Japan is one of monetary policy *ineffectiveness*, as Keynes had argued would be the situation in depression economies, rather than the alleged monetary policy *inactivity*. It would ultimately require a shove in aggregate demand to bring the economy back to full employment. Such a push finally came from the export demand and gradually spread to real business investment. (Section V)

II. Financial Sector Changes: 1980s and 1990s

By the beginning of the 1990s the Japanese economy had already made substantial departures from the carefully laid economic structures of the post-war years for corporate sector and financial sector management. In the post war years, Japanese economy had created a banking structure, distinctly different from the Anglo-Saxon model of financial intermediation, where "a bank not only provides loans to a firm, but also holds its stock. Typically, a firm develops a relationship with a particular bank and relies on its steady support in funding over the long term. In return, the firm uses the bank for major transactions from which the banks earn fees and profits." Government regulation played a crucial role in ensuring depositor protection so that the savings of the household sector formed an assured fund base for the banks. Further, regulations prevented the use of bank funds for speculative purposes and insisted their deployment in productive investments in industry. In return banks were in a position to use the resulting leverage to ensure that their funds were profitably employed and properly managed.[2]

The bedrock of the government-bank-depositor-firm relationship was diluted during the 1980s through a series of policy measures aimed at liberalizing the economy. The Plaza Accord of 1985 guaranteed the Japanese economy access to the US markets through trade and investment. In return Japan had to concede a massive appreciation of Japanese Yen. The price of yen vis-à-vis the US $ halved in three years, from 260 in February 1985 to 123 in November 1988. With external competitiveness of the Japanese industry adversely hit because of the massive appreciation of domestic currency, profitability of the domestic firms were eroded substantially. Even before the Plaza Accord the government had started easing regulations on banks by allowing them greater freedom to select avenues for investment of bank deposits. Thus banks could diversify into overseas operations, lending against real estate and stock market investments, a liberty which they used fully. Bank credit was primarily catering to medium and small firms since many of the large corporates had switched to the stock market for external funds which was witnessing a bullish run. Small and medium non-manufacturing business firms and real estate business made generous use of bank credit to invest in land. As a result financial institutions across the board were heavily exposed to real estate related industries. Wood (1992) estimates that property, directly or indirectly, supported as much as 80 percent of the total loans of Japanese banks.[3] When the speculative bubble burst asset prices fell

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[2] For details see Explaining Japan's Decline by C.P. Chandrasekhar & Jayati Ghosh, July, 09, 2002. www.networkideas.org

[3] The Bubble Economy: Japan's Extraordinary Speculative Boom of the '80's and the Dramatic Bust of the '90' by Christopher Wood, The Atlantic Monthly Press, 1992

sharply - stock prices fell ahead of land prices. At the end of 1989, the total market value of the first section of the Tokyo Stock Exchange was 591 trillion yen, but only three years later at the end of 1992, it dropped by more than 50 percent to 281 trillion yen. Between 1990 and 1993, there was a near 50% drop in land prices. (Statistical Handbook of Japan, 2003)[4]

Asset price-deflation marked the beginning of a long and precipitous decline of the financial system with massive contraction in bank credit, huge pile up of bad debt with losses upto 17% of GDP in dealing with non-performing loans, large-scale failures of both smaller cooperative type financial institutions and larger banks leading to the dissolution of 110 deposit-taking institutions under deposit insurance system by the year 2000 (Nakaso, 2001)[5] Debt deflation also affected the real economic sector, particularly investment sharply. Miyakodayori, a newsletter published by Research Institute of Economy, Trade and Industry of Japan writes, `with the pervasive debt overhang, transactions among corporations have been shrinking due to concern about the soundness of their business partners. Corporations with excessive debt have not been able to aggressively invest.'[6] On the other hand, banks could not expand corporate loans since the risk in the business sector was too high. Finally, the interplay of the real and financial forces led to a vicious circle of uncertainty, shrinkage of demand, procrastination and more uncertainty.

The policy response to the problems of the banking sector has been to push forth strongly for liberalization of the financial system with *improved banking supervision and regulation*. The mainstream reading of the travails of the financial sector has been to place the blame squarely on the existing state regulations of the banking sector within a financial system that had already made its transition to a competitive structure. The following quote of Hiroshi Nakaso of the Financial System Division of the Bank of Japan expresses this point succinctly. According to Nakaso, ``the crisis erupted when the gap between competitive pressures in the financial markets and a `convoy' style of banking supervision and regulation that in effect ensured the viability of the weakest banks became unsustainable. The crisis was *accentuated* by the formation and bursting of the bubble."[7] Note that Nakaso does not link the asset bubble with the changes in financial policy. Rather he considers the formation and bursting of asset bubble as an independent development that aggravated the crisis. Not surprisingly then, the transition to a financial system based on competitive market principles regulated by an independent statutory body was adopted as the most natural and inevitable option. In addition, restructuring of the corporate sector and development of more liquid capital markets had to be actively planned to weaken the close ties between the bank and industry.

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[4] Statistical Handbook of Japan, 2003, Edited by Statistical Research and Training Institute, and published by Statistics Bureau. www.stat.go.jp/english/data/**handbook**/

[5] Hiroshi Nakaso (2001) The Financial Crisis in Japan during the 1990s: how the Bank of Japan responded and the lessons learnt, Bank for International Settlements Paper, No.6, Oct.

[6] See Miyakodayori No.17, 2001. Miyakodayori is an Asia economic policy newsletter published by RIETI http://www.rieti.go.jp/en/miyakodayori/017.html

[7] Nakaso (2001)

Table 1: Main Macroeconomic Indicators for the Japanese Economy: 1990 – 2003

	Year on Year Growth: (in percentage)			Unemp-loyment Rate (%)	Inflation based on CPI (%)	*Corporate Bankruptcies*		Nikkei 225 (Average)
	Real GDP	Industrial Production	Credit to Private Sector			Cases	Amount of Liabilities (100 million ¥)	
1990	5.2	5.0	11.6	2.1	3.1	6468	19958	23849
1991	3.4	-0.7	6.9	2.1	2.8	10723	81847	22984
1992	1.0	-6.0	3.4	2.2	1.6	14069	76014	16925
1993	0.2	-3.6	2.5	2.5	1.3	14564	68476	17417
1994	1.1	3.1	-2.9	2.9	0.4	14061	56294	19723
1995	1.9	2.1	0.1	3.1	-0.3	15108	92411	19868
1996	3.4	3.3	1.3	3.4	0.4	14834	81228	19361
1997	1.9	1.1	0.2	3.4	2.0	16464	140446	15259
1998	-1.1	-6.8	-0.6	4.1	0.2	18988	137483	13842
1999	0.1	2.6	-0.7	4.7	-0.5	15352	136214	18934
2000	2.8	4.3	-1.6	4.7	-0.6	18769	238850	13785
2001	0.4	-9.1	-1.8	5.0	-1.0	19164	165196	10543
2002	-0.4	2.8	-3.9	5.8	-0.6	19087	137824	8579
2003	2.7	3.5	-4.8	5.7	-0.2	16255	115818	10677

Source: (i) Bank of Japan Statistics and Other Key Statistics, http://www.boj.or.jp/en/stat/sk/data/skeall.pdf ; and (ii) Bank of Japan, Monetary Survey, Long-term Time-series Data, http://www.boj.or.jp/en/stat/dlong_f.htm

Financial system reform, "Japanese Big Bang," commenced in November 1996 under the three principles of "free, fair and global". As the first step, the revised Foreign Exchange Law was changed to totally liberalize cross- border transactions in April 1998. Then, the Financial System Reform Law alongwith revisions to the Banking Law, the Securities and Exchange Law, and the Insurance Business Law – covering institutions that were required to implement the Financial System Reform - were enforced in December 1998. These Laws govern a range of practices leading to deregulation and liberalization of the financial sector: revising regulations on the business scope and organizational format of financial institutions; easing entry barriers to the financial industry; deregulation on products and service; and improving market infrastructure. In the year 2000, a separate financial Supervisory Agency separate from the Ministry of Finance was set up. The newly appointed Minister for Financial Services Hakuo Yanagisawa in a public meeting reasserting the objective of greater efficiency and greater competitiveness announced the task before him - disposal of non-performing assets, recapitalization of banks to ensure capital adequacy ratio; stringent provisioning norms; reduction of bank cross-shareholding; revitalization of securities market; and enlarging opportunities for private institutions in the financial market.[8] In the recent years, reorganization of the financial sector through mergers and establishment of holding companies have been rapidly

[8] Japan's Financial Sector Reform: Progress and Challenges, Hakuo Yanagisawa M.P. Minister for Financial Services, Japan 09/07/2001 www.fsa.go.jp

promoted and foreign financial institutions are increasingly penetrating the Japanese market.

Another important step in the direction of deregulation is the dilution of deposit insurance system. Until now, deposits were fully protected by the deposit insurance system even if the financial institutions went bankrupt. This had made it obligatory for the Bank of Japan to act as the lender of last resort and pump in money to save the loss making financial institutions from bankruptcy and prevent systemic bank runs, a system which prevented large-scale systemic failure in the 1990s. In a major reform of the deposit insurance system, a cap, limiting the maximum protection amount to 10 million yen, was introduced in 2002.

It is obvious that the Japanese financial system and the unique relationship it had fostered between industry and bank-based finance, with finance serving the real economy interests and a firewall separating banking and speculative activities, has been overhauled drastically. The objective before the Japanese economy is greater efficiency and greater competitiveness, and to rebuild the Japanese financial market into an international market comparable to the New York and London markets – ironically the very institutions Keynes had been the most critical about.

At this juncture, a question that must be haunting many Japanese people, and particularly many of the older generation, is whether the recession in the Japanese economy would have been less severe had the old financial system been allowed to exist. The old system had given the Japanese banks `deep pockets' to extend credit to industry that would have help tide over economic crisis involving crisis of private business confidence. The governmental control on banks and industry could have ensured that the private sector contribution to aggregate spending did not fall too much, while public spending through deficit spending maintained the aggregate spending at respectable levels.

In fact, allocative efficiency has always been one of the prime objectives of public sector banking, which gave rise to the notion of `social banking'. The Japanese financial system had broadly followed this principle. Allocative efficiency in the economy with the banking resources allocated so as to maximize the social returns of investment (as against the private returns) in the economy must be distinguished from operational efficiency of banks that sees each individual bank as a profit maximizing agent. The sole focus of the neo-liberal reformers is on operational efficiency – a micro concept, whereas hitherto the Japanese financial system had been governed by the macroeconomic allocative efficiency principle. It is obvious therefore that the implications of shift in banking objective would be felt during the economic recession.

Supply-side response of banks during the downturn of the 1990s was impaired by the requirement of prudential capital and strict loan loss provisioning standards for financial intermediaries according to international financial norms. As a result, banks that were already severely affected by debt-deflation became even more conservative in their lending practices, instead preferring to invest in gilt-edged bonds that offered secure returns with near zero risk weightage for capital provisioning. On the other hand,

government investments were diverted towards recapitalization of banks to a very substantial extent such that the financial sector was acting as a sink sucking in public money that could have otherwise regenerated the economy through demand push.

With the entry of foreign banks, Japanese banks have been conceding their market share to foreign banks. The penetration of foreign banks in Japanese financial system including the sell-off of major Japanese banks to non-Japanese investors (as in the case of Long Term Credit Bank) has meant that the regulatory and monetary authorities have lesser control. Not only is the regulator's ability to practice moral suasion minimum, when dealing with an entity more focused on the expected returns from a transaction and less sensitive to domestic goals promulgated by the government, even more dangerous is the inability of the monetary authorities to prevent capital flight by the foreign banks in the face of real or imagined crisis in the domestic economy. The ensuing instability across the financial system could then have a self-fulfilling effect causing severe damage to the domestic economy, as the recent Argentine example illustrated.[9]

III. Anti-deflationary Policies: Fiscal stimulus and Monetary Easing

The fiscal situation during the second half of the 1980s in Japan would have pleased any Central Banker and for the Bank of Japan, trying to enforce monetary discipline and price stability, it was particularly satisfying. Japan had, since the FY1980 budget maintained the goal of reducing and eliminating the issuance of special deficit-financing bonds, through restraint on the expenditure side. Partly as a result of the bubble economy and the increase in tax revenues in the latter half of the 1980s, Japan finally succeeded in formulating the FY1990 budget without issuing special deficit-financing bonds for the first time in 16 years. Government bond issues, which amounted to more than one-third of total expenditures in FY1979, gradually declined in the 1980s and recorded a low of 9.5% of total expenditures in FY1991.

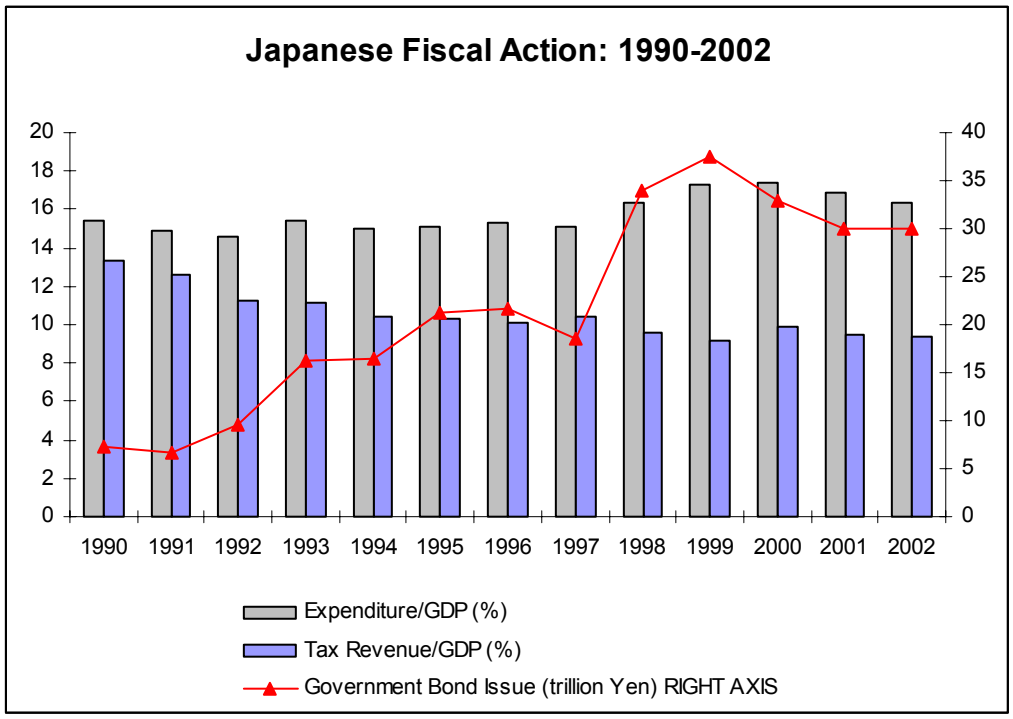
The restraint on public expenditure and issue of government bonds had, however, to be soon abandoned as the recession set in and the need for a strong fiscal stimulus was recognized. The tax-ratio declined from 13.3 percent in FY1990 to 9.4 percent in FY2002 due to the depressed conditions in the economy and the tax cuts announced by the government. Once again, the issue of special deficit financing bonds was stepped up and reached unprecedented levels after the Asian financial crisis and collapse of domestic financial institutions. (see Figure 2) Public money was used for public works in social infrastructure projects and injections into the banking system against non-performing loans of the failing financial institutions.

The substantial increase in bond-issue hiked the public debt-GDP ratio. The public sector's gross liabilities in March 2003 stood at 161 percent of GDP, up from around 60 percent of GDP in 1990. Yet the contribution of public expenditure to national product went up by a small 3 percentage points. One of the reasons why public expenditure to

[9] See http://www.networkideas.org/featart/featart_Argentina.htm for a set of papers on Argentina's crisis.

GDP ratio didn't rise appreciably was because a significant share of the additional bond issue went into covering the revenue declines from the tax breaks that the government announced. The latter was to stimulate private consumption expenditure and also private investment. Normally the multiplier effect of tax relief in a depression economy would be much less than direct expansion of public spending. The difference is particularly sharp for the Japanese economy. In the context of the Comprehensive Economic Measures of April 1998, which combined major tax cuts with social infrastructure investment to the tune of 16 trillion Yen, the Ministry of Foreign Affairs calculations show that the income multiplier for tax cut is 0.46 whereas for public investment it is 1.46, establishing the greater effectiveness of public expenditure for demand generation in the economy. Rather than providing tax relief, had the Japanese government directly spent the money the benefit to the economy would have been larger.

FIGURE 2



Source: *http://www.mof.go.jp/english/budget/brief/2002/2002-03.htm*

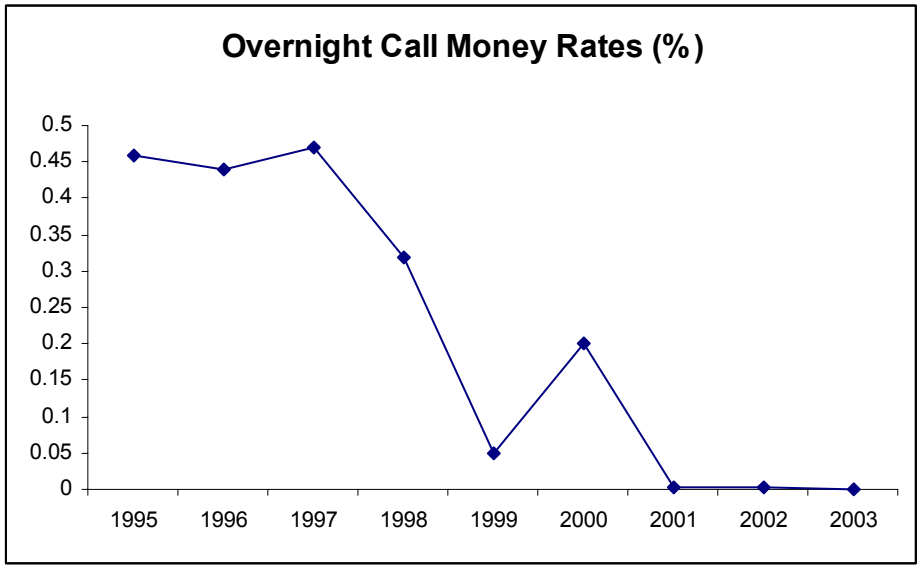
When the size of the economy is as large as that of the Japanese economy, the additional public spending required to raise public expenditure to GDP ratio would automatically be very large. Viewed from this perspective the growth of public spending has clearly been conservative. Also given the massive size of the Japanese economy, the overall rise in public spending was not enough to cover the shortfall in private demand. (See Table 2 for contribution of private and public demand to aggregate spending) Much larger doses of pump priming was needed to close the output gap.

In the past few years, since FY2000 there's been a decline in the contribution of public expenditure to GDP. The reversal is part of the package of fiscal reform legislations that

was passed in 1997 (Fiscal Structural Reform Act, 1997) but had to be kept in abeyance due to the continuing stagnation and the need for public funds to stabilize the financial system. Lately the balance has tilted clearly in favour of fiscal reforms. Ever since the quarter Oct-December 1999 public investment has continuously declined. The decline accelerated to double digits in 2003. Development Bank of Japan (2003) figures show that the public investment now accounts for only 5% of GDP and is expected to decline further given the `continuation of structural reforms and financial difficulties.'[10]

In respect to monetary policy, Japan has consciously followed a monetary easing policy for several years now, especially after the Asian crisis. Bank of Japan had tightened monetary policy around mid-1989 with a view to contain inflationary expectations and maintain price stability. It raised the discount rate to more than 6 percent (Aug. 1990) which was higher than the level prevailing at the time of Plaza Accord. The Ministry of Finance also introduced restrictive laws and regulations for land transactions. These changes possibly triggered the bursting of the bubble. After June 1991, monetary policy was eased gradually though the Bank of Japan at that time was still pledged to the anti-inflationary objective. The severe debt deflation that followed had not figured as a possibility then. By Sept 1995, the official discount rates had been reduced to 0.5 percent, the lowest level in Bank of Japan's history.

FIGURE 3



Source: Bank of Japan Statistics and Other Key Statistics, http://www.boj.or.jp/en/stat/sk/data/skeall.pdf

Monetary policy in the second half of the 1990s became `ultra-easy'. Interest rates were continuously declining and by 1998 had come very close to the zero mark. In Feb.1999 BOJ adopted the `zero interest rate policy'. This was a combination of a near zero overnight rate and the commitment to maintain it "until deflationary concerns are over."

[10] Development Bank of Japan (2003) Recent Trends in Japanese Economy: A Medium term Scenario for the Sustainability of the Japanese Economy, Research Report No.36. Feb.pp.5.

It was non-conventional in the sense that the interest rate was set at zero, an extreme level, and that the near-term future policy stance was explicitly made clear.

In March 2001, the BOJ switched from the usual approach of reduction in the target short-term interest rate to quantitative easing because by that time it was pursuing a target very close to zero. As a result, the possible stimulus obtained through further reduction in the interest rate target was likely to be limited, the BOJ argued. Under the quantitative easing formula, the BOJ conducts open market operations aimed at increasing the money supply. The quantitative easing programme is continuing with periodic intensification.

IV. Monetary Policy and Prices

Despite the efforts of the Bank of Japan to maintain an (unambiguous) ultra-easy liquidity situation for most of the period, the role played by monetary policy in alleviating the Japanese crisis has been shrouded in controversy. Many commentaries on the Japanese crisis have alleged that the failure to prevent deflation is in itself an evidence of the failure of the Bank of Japan to follow an expansionary policy aggressively over a sustained period. This argument which can be traced to Friedmanite monetarism has the following logic: since an expansion in money supply by the monetary authorities, translates to a proportionate price rise through the quantity theory of money equation, given the exogenous nature of money supply it should always be possible to engineer price rise through monetary expansion. Bank of Japan responded to this criticism by switching from targeting short-term interest rates to quantitative monetary easing policy by adopting the current account balance as the direct target of its financial guidance policy since March 2001. As a result of this policy, the monetary base, i.e. the total of Bank of Japan's current account balance and cash in circulation has seen double digit increases but money stock has been growing at 1-2% on the previous year. The money multiplier declined from 13 in the first half of 1992 to a record low of under 7 in the recent period.[11] In terms of the Cambridge equation, the growth in monetary base has been absorbed by the decline in money multiplier and hence, the effect of quantitative easing policy has not materialized. It is worth noting here that even the small growth of money stock of 1-2 percent has been propped up by the strong growth of lending to the government, as credit to the private sector – lending and investments in industrial debentures and stocks - continue to decline.

A more sophisticated causation running from monetary control to prices has been suggested by Paul Krugman (1998).[12] Krugman blames the monetary authority for not being able to generate inflationary expectations, which is the only effective way to reverse the deflationary spiral. Unlike the monetarists, Krugman identifies the Japanese

[11] Development Bank of Japan (2004) Recent Trends in Japanese Economy: A Medium term Scenario for the Japanese Economy with a Special focus on the Flow of Funds and Finance, Research Report No.44. March.

[12] Paul Krugman (1998), "It's BAAACK! Japan's Slump and the Return of the Liquidity Trap," Brookings Papers on Economic Activity.

case with the Keynesian liquidity trap, where money supply is irrelevant at the margin since the nominal interest rates are already at near zero levels. Increase in high powered money does not spur aggregate demand through interest rate fall. The problem therefore is how to reduce interest rates in the economy. At this point, Krugman draws on the Fisher's equation of interest rate determination to argue that the zero lower bound on nominal interest can be surpassed by generating *inflation* that would push down the real rate of interest.

But this is begging the question, since the Japanese economy was already in recession with falling aggregate demand and deflation. In a deflationary state, further spending in the current period becomes unattractive and the current level price is pushed down. Only when people realise that the prices have bottomed out and would not fall further, they might begin to spend. It is here, Krugman believes, that the Central Bank must intervene and produce inflationary expectations through a credible commitment to inflation over a future period. Thus Krugman proposes managed inflation, `since deflation is the result of an economy "trying" to get the expected inflation it needs, to avoid deflation one must provide that expected inflation by credibly promising that future price levels will be sufficiently high compared with the present.'[13]

Keynesians have taken a strong objection to Krugman's stylization of Japanese slump within the liquidity trap framework and yet mixing it with monetarist relationship so that the original conclusion of Keynes on ineffectiveness of monetary policy in an economy stuck in a liquidity trap is turned on its head. Kregel (2000) confronts Krugman on the use of the Fisher's equation in his model and shows how the difference in the result is related to this crucial assumption. Essentially, he makes two points – one theoretical and the other practical, which are of relevance here. He emphasizes the distinction between the Fisherian time preference theory and Keynesian liquidity preference theory of interest rate determination. In Fisher's *time* preference approach the rate of interest is the discount of future over present income that makes their utility equal at the margin, while for Keynes *liquidity* preference represents the return that must be paid on illiquid assets to make investors indifferent to holding more liquid assets. Since time preference is a relation between real income today and in the future, it would be disturbed by changes in prices. And this is the sense in which Krugman uses the relationship when he talks of using the inflation to drive a wedge between nominal and real interest rate. Keynes' objected to the Fisher's relation because `Fisher's argument that the money rate of interest should automatically reflect a perfectly foreseen rise or fall in the price level overlooks the impact of a rise or fall in interest rates on the capital value of existing stocks of financial assets.'[14]

This brings us to the other more practical point that Kregel emphasizes in Keynes' original argument. Even if monetary authority is able to create inflation, it would be extremely difficult to hold down interest rate (yield on bonds) at the long end of the

[13] Paul Krugman, Can deflation be prevented? (February 1999) http://web.mit.edu/krugman/www/deflator.html

[14] Jan A. Kregel (2000) Krugman on the Liquidity Trap: Why Inflation Won't Bring Recovery in Japan, Jerome Levy Economics Institute Working Paper No. 298, March. Pp.5

maturity spectrum, though perhaps the monetary authority is able to control the short term interest rate. This happens because of the liquidity preference of the investor who would reason that to offset the fall in capital value as a result of higher interest rate the rise in interest rate at the longer end must be higher. Thus it would be practically impossible to keep the yield curve stationary while the prices are rising. Keynes' theory was based on firsthand observations on the behaviour of bond market, so it is not surprising that empirical evidence would disprove Fisher's relation, as we will see below for Japan.

Krugman was not alone in suggesting an inflation target for the Japanese economy. Such a view was being debated in the Ministry and the Bank of Japan and outside. Bank of Japan monetary policy board member Nobuyuki Nakahara proposed `setting a target for base money to create inflationary expectations and get the Japanese economy out of its liquidity trap,' echoing exactly what Krugman was emphasizing. Deputy vice-minister for international finance Takatoshi Ito penned for London's Financial Times, "many countries have adopted inflation targeting to establish a clear objective for monetary policy and to make their (often newly) independent central banks accountable. The Bank of Japan could commit to an inflation target of, say, 1-3 percent, to be achieved in two years.'[15] Kenneth Roggoff of the IMF, stressed the need for clear Bank of Japan communication strategy which would explain that (a) the BOJ intends to restore positive inflation within a reasonably short time frame and (b) the BOJ has ample capacity to restore positive inflation if it chooses to do so.[16]

However, Rogoff and the others do not suggest anything beyond the quantitative easing policy to demonstrate either the *intent* or the *ability* of Bank of Japan to restore positive inflation.[17]

In the recent months with the Japanese economy gaining momentum and aggregate demand expanding, interest rates are beginning to nudge upwards as Kregel in referring to Keynes' theory had stated. Figure 4 traces the yields on government bonds across the maturity spectrum. There's been a slight steepening of the yield curve between the end of Oct-Dec.2003 quarter and the end of first quarter of 2004. More recently, the yields on long-term bonds have risen very sharply. For instance, the yield of 10-year government bond increased to 1.92 percent in August this year, up from 0.4% in June 2003. Even when the short term rates are steered by monetary authorities and remain low, yields on long term bonds have started rising. And this would happen until the level of long-term interest rates themselves becomes an explicit policy objective of the Central Bank. But then interest rates and not prices should be the leading indicator of monetary policy.

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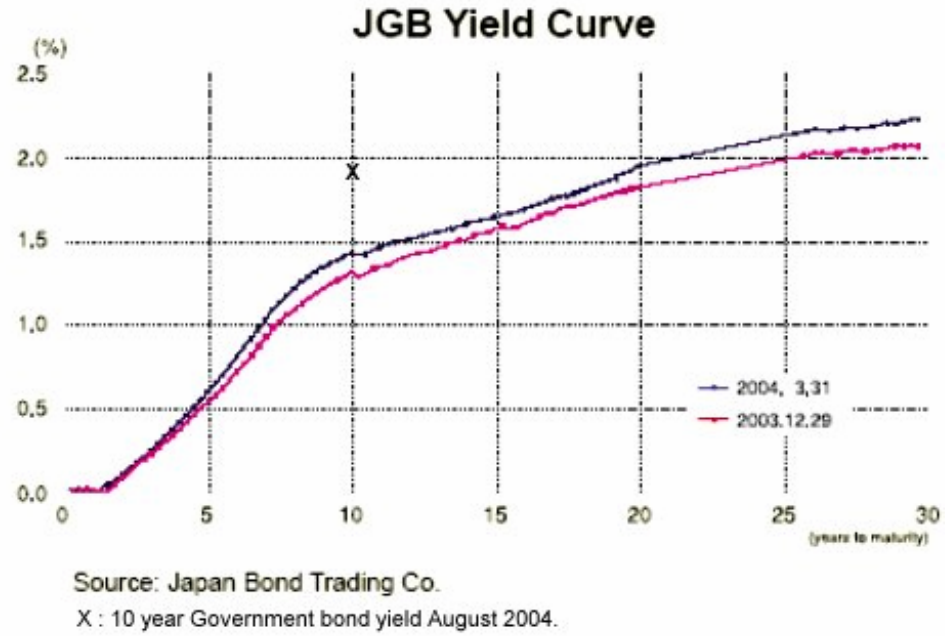
[15] http://www.atimes.com/editor/AJ20Ba01.html, October 20, 1999.

[16] Kenneth Rogoff (2002) Revitalizing Japan: Risks and Opportunities: A Commentary, International Monetary Fund, Published in The Nihon Keizai Shimbun, November 7. http://www.imf.org/external/np/vc/2002/110702.htm

[17] In November, 2002 Rogoff commented `if the central bank were to print enough money to buy back all government debt, there would be massive inflation, with or without a weak banking sector. So surely some lesser level of quantitative easing should do the trick.' http://www.imf.org/external/np/vc/2002/110702.htm

FIGURE 4



Source: Japanese Government Bonds, Quarterly News letter of the Ministry of Finance of Japan http://www.mof.go.jp/english/bonds/jgb2004_04e.pdf

V. Export Growth: The Ultimate Panacea

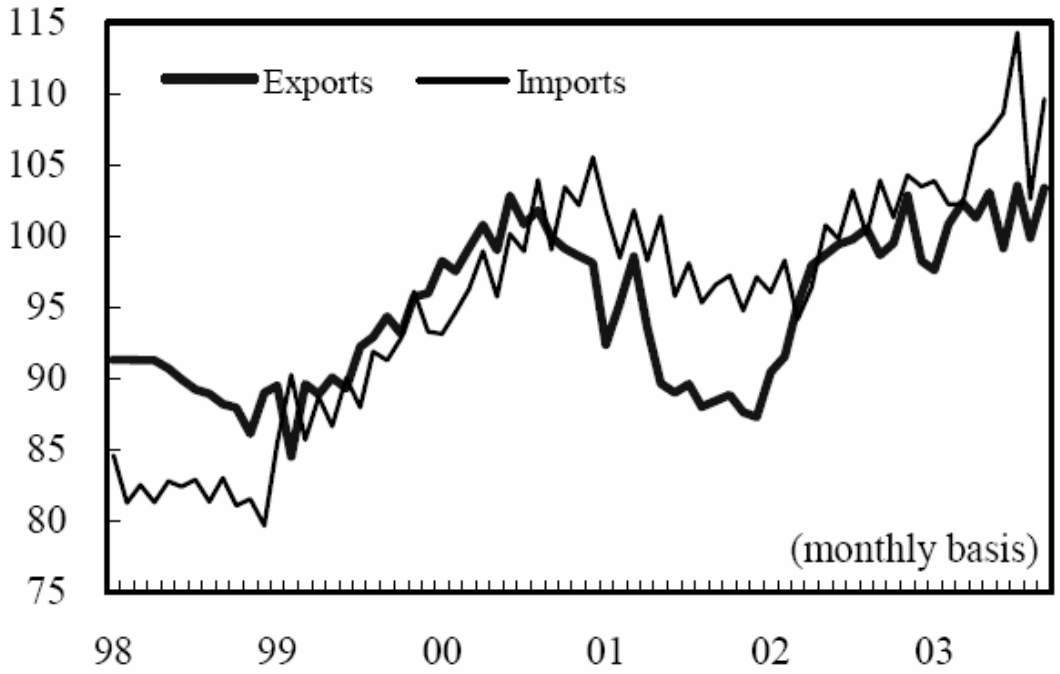
Development Bank of Japan Research Report, 2003 dates the recovery in real GDP growth to January-March 2002. `Led by *recovery of exports*, real GDP turned from a decrease of 3.3 percent on the previous year in Jan-Mar 2002 to an increase of 1.5 percent in July-September, the first increase in five quarters.'[18] The recovery in exports has been mainly in automobile exports to the United States and machinery exports to Asia. In addition, there was a surge in export demand for hi-tech products like flat-screen television sets and computer chips from the several Asian countries. Barring a few temporary spells like the July-September quarter in 2002 when the recovery of IT-related demand faltered, the steady export growth has been the most important factor in reviving aggregate demand in the Japanese economy.[19]

[18] pp.5, Development Bank of Japan Research Report (2003) No.36.

[19] Yen vis-a-vis US$ has appreciated from 131.5 in 2001 to 107 in 2003. In the first seven months of 2004, foreign exchange value of Yen has been declining.

FIGURE 5

Export and Import Volume Indices (2000 =100)



Source: Recent Trends in Japanese Economy: A medium-term trend in Japanese economy with special focus on flow of funds and finance, March 2004, Development Bank of Japan, Research Report, No. 44.

The recovery in real private plant and equipment investment has followed close on the heels of growth in exports. It started rising since July-September 2002, and since the beginning of FY2003 active investment particularly in digital household electronic appliances has led the growth of GDP.[20] By July-September 2003, plant and equipment investment had surpassed the peak recorded in the IT boom era. Companies in key sectors of the manufacturing industry, such as electrical appliances, automobiles, and steel, have begun increasing their investment in plant and equipment.

In Figure 5, the growth of imports has followed the recovery in exports with a lag. As the growth in domestic investment regenerates economic activity, it would simultaneously give rise to import demand.

The expansion in aggregate demand led by spurt in export growth and real business investment, hopefully to be followed by growth in private consumption demand, should automatically solve the problem of Japanese deflation. As aggregate demand in the economy recovers and aggregate demand curve shifts outwards, price level in the economy would rise. Unless, there is a major offsetting influence, for example a drastic cut in public expenditure or reversal in export growth, it is a matter of time before the

[20] Development Bank of Japan Research Report (2004) No.44

inflation turns positive. Ultimately, it is the effective demand that holds the key to economic recovery.

In Conclusion

We have reviewed the macroeconomic policy mix in Japan during the 1990s, a decade during which the economy experienced severe recessionary conditions. We have argued that the recessionary conditions and the difficulties in economic recovery that Japan experienced are not unrelated to the macroeconomic policies adopted in the recent years by the Japanese State. Countercyclical economic policies have largely been a failure. Given the near liquidity trap situation in the economy and the doctrinaire methods of Japanese monetary authorities, not much could be expected from monetary policy. Expansionary fiscal policy could have provided the necessary demand push if only the fiscal stimulus had been large enough and the nature of public expenditure such as to induce a significantly high multiplier effect in the economy. This was obviously not the case. In the past few years, fiscal policy has been clearly contractionary despite the continuing demand deficit in the economy.

Restraint on fiscal expenditure is part of the neo-liberal reform process that has wholly transformed the structure and functioning of the Japanese financial system over the last two decades into an `efficient' and internally & externally `competitive' market-based system of the Anglo-Saxon variety. This is a major departure from the state controlled system of financial intermediation in Japan with a cooperative and a mutually beneficial relationship across actors – the depositors, the banks, and the industries. The new architecture of the financial system has played a substantive role in giving rise to the downturn in the economy, in prolonging the downturn, and in blunting the macroeconomic policy responses to the downturn. The asset price bubble in the second half of the 1980s was the result of speculative lending by the financial institutions confronted with the freedom to select their investment avenues freely, which now included the stock market and other asset markets. The consequent bursting of the asset bubble, debt deflation and slowdown in economic activity might have been moderated with a more borrower-friendly credit policy. Instead the new norms of profitability and safety imposed on Japanese banks made them more tight-fisted. Finally, a substantial diversion from the public expenditure pool was taking place in the form of bank recapitalization, which in the absence of further on-lending by banks did not help in economic recovery.

We will end with a question that automatically arises from the analysis presented in this paper, but we have left unanswered: why has the Japanese State followed economic policies that are completely antithetical to the Keynesian anti-depression policies? In other words, why have these choices seemed so obvious to a developed country State like the Japanese state, not circumscribed by the compulsions of most third world States? It is important to hold up to scrutiny the broader political-economy aspects of the issues examined in this paper for a fuller understanding of the national and international economic policy-making.

Table 2: Contribution to Change in Real Gross Domestic Expenditures by Component (in percent)

FY	Real Gross Domestic Expenditure	Domestic Demand	Public Demand	Private Demand sum of (i) to (iv)	Private Consumption (i)	Residential Investment (ii)	Non-residential Investment (iii)	Private Inventory (iv)	Exports of Goods and Services	Imports of Goods and Services
1996	3.6	3.7	0.1	3.6	1.5	0.6	1.4	0.1	0.7	-0.8
1997	0.6	-0.4	-0.3	-0.1	-0.4	-1.0	1.2	0.2	0.8	0.1
1998	-1.0	-1.2	0.5	-1.7	0.4	-0.5	-0.9	-0.8	-0.4	0.5
1999	0.9	0.8	0.7	0.1	0.2	0.1	0.0	-0.2	0.6	-0.5
2000	3.0	2.8	0.2	2.6	0.6	0.0	1.5	0.5	1.0	-0.8
2001	-1.2	-0.6	0.0	-0.7	0.7	-0.3	-0.6	-0.5	-0.8	0.3
2002	1.1	0.4	0.0	0.3	0.6	-0.1	-0.6	0.4	1.3	-0.5
2003	3.2	2.4	-0.6	2.9	0.8	0.0	1.9	0.2	1.3	-0.4

Source: Bank of Japan Statistics and Other Key Statistics, http://www.boj.or.jp/en/stat/sk/data/skeall.pdf