Comments on: “Japanese monetary policy: 1998-2005 and beyond” by Takatoshi Ito

Peter J Morgan[1]

Professor Ito’s paper is a very thorough and balanced review and assessment of the development of Bank of Japan (BOJ) policy during the period of deflation from 1998, when the BOJ obtained legal independence, to the present. This period coincided with the terms of BOJ governors Hayami and Fukui and a number of important policy innovations. The experience of this period certainly provides important lessons for the conduct of monetary policy.

The paper divides into three main parts:

1. A description of the major developments of Japanese monetary policy through 2003 including the adoption and ending of the zero interest rate policy (ZIRP), and the implementation of quantitative easing (QE);
2. A review of the debate in the monetary policy meeting (MPM) on inflation targeting;
3. A description of monetary policy in 2003-06, focusing on the evolution of the QE policy, the refinement of the BOJ’s criteria for exiting from QE, the debate about the process for ending QE, and the actual exit in March 2006.

Professor Ito’s paper raises, either implicitly or explicitly, a number of very significant issues, and I would like to focus on these issues in my comments.

I. Determinants of monetary policy responses

The first issue is the choice of policy responses by the Bank of Japan in the case of a liquidity trap, or what Prof Ito prefers to call a deflationary trap, when short-term interest rates have already been lowered to zero. By definition then, these are unconventional policy measures.

The table below shows the menu of alternatives suggested in Prof Ito’s paper, plus a couple of additional suggestions from the widely cited speech by the current Fed chairman Ben Bernanke (2002) on this subject.

Table 1

Unconventional monetary policy measures

		BOJ	**Ito**	
1.	Commitment to keep short-term interest rates low	x	x	Weak
2.	Explicit ceilings on long-term rates			
3.	Monetise domestic government debt	x	x	
4.	Expand the size of the balance sheet - QE	x	x	
5.	Coordinated fiscal and monetary policy			Strong
6	Foreign exchange intervention		x	
7.	Real asset purchases		x	

Sources: Bernanke (2002); Ito (2005); Svensson (2000).

[1] Chief Economist, Asia-Pacific HSBC.

The first four options are fairly straightforward extensions of conventional monetary policy, including various ways to influence the level of interest rates further out the curve and to expand the size of the central bank's balance sheet. Their chief virtue is that they can be carried out in a straightforward manner using the same kinds of operations that central banks use anyway, and they do not require cooperation from other parts of the government. Their main disadvantage is that their impact is very likely to be limited in a situation of deflation, where interest rates all along the curve generally are already very low, precisely because the demand for funds is weak. In these conditions, the impact on portfolio behaviour or aggregate demand of a further decline of interest rates is likely to be very small. Therefore, I have classified these as "weak" policy options.

I have classified the options 5-7 as "strong", because they all have a much clearer transmission mechanism for boosting aggregate demand. Coordinated fiscal and monetary policy uses monetary policy to monetise government debt issuance resulting either from higher expenditures or tax cuts. Foreign exchange intervention, as advocated perhaps most strongly by Lars Svensson, increases export demand by lowering the exchange rate and raises the price level via higher import prices. Finally, real asset purchases raise private sector wealth, thereby encouraging consumption and investment.

The main disadvantage of the first two strong options is that they require coordination with other government entities. In particular, foreign exchange intervention requires at least passive acquiescence by Japan's trading partners, especially the United States, not necessarily easy to obtain. Real asset purchases do not require coordination, but they have significant consequences for income distribution, asset allocation and politics, which makes them difficult to adopt without some broader consensus being achieved.

From this classification, it is clear that the BOJ chose only weak options, and perhaps the key question is: why was this the case? (Technically, the BOJ did buy small amounts of equities and private debt, but these operations were explicitly divorced from monetary policy.)

Prof Ito suggests that the choice of only weak policies, and the slow pace of doing even that, partly reflected a bias against inflation. There certainly is evidence to support such a conclusion, which he cites, including the BOJ's reluctance and tardiness in adopting unconventional measures, its frequently voiced concerns that low interest rates retard the restructuring process and distort asset allocation, and various comments about "good deflation". Prof Ito suggests that the independence acquired by the BOJ following the adoption of the new Bank of Japan Law in 1998 creates a bias towards hawkishness as a way to display that independence, and this seems quite possible.

The second issue is that of accountability. The BOJ evidently did not perceive itself as having a strong mandate to "own" the problem of deflation, that is, to firmly commit to taking necessary steps to achieve positive inflation in a timely way. Instead, it tended to react tactically and reluctantly. Prof Ito suggests that this problem could be cured by the BOJ having an explicit inflation target. However, it is not clear that the BOJ could achieve an inflation target using only weak unconventional policies. Ultimately, this is probably the main reason why the BOJ strongly resisted adopting an inflation target.

As mentioned above, the first two strong policy options require some sort of policy coordination. The Japanese government clearly has not wanted to expand fiscal policy, given its worries about the high government debt level. However, if the BOJ can monetise the debt, then it is not obvious that this concern is rational. Regarding currency intervention, the BOJ cited the legal primacy of the Ministry of Finance in setting foreign exchange policy, but comments by the Ministry did not suggest it was opposed to activity by the BOJ in this area. However, one can imagine that the US government would not have been too enthusiastic about this. To be sure, it did acquiesce when the Ministry bought a total of JPY 35 trillion of dollars between January 2003 and March 2004. However, this intervention was aimed mainly at stemming the rise of the yen during a period when the private sector signally failed to recycle the current account surplus, and the intervention stopped when normal private capital outflows resumed. This is somewhat different from an attempt to substantially devalue the yen.

Regarding asset purchases, the BOJ seems to have regarded these as possible, but only to be used in the case of a deflationary spiral. However, in the absence of policy coordination, the implication of strong accountability is that the BOJ should be prepared to adopt such policies if needed to fulfil its mandate. Therefore, the extent of the BOJ's mandate remains unclear, and a shift to an inflation target could clarify this.

II. Quantitative easing - impact and exit conditions

Much of the paper is devoted to issues concerned with the timing and method of the ending of quantitative easing. Prof Ito is generally critical that the BOJ may have exited too soon. However, all of this discussion begs the more fundamental question of whether or not quantitative easing had a significant impact. If not, then this debate is beside the point. The paper would benefit from a more thorough discussion of this issue.

Professor Ito suggests that quantitative easing may have had some impact, but I believe the evidence for this is pretty scant. The basic theoretical reason for scepticism is the widely cited point that, under zero interest rates, short-term paper is equivalent to cash. Therefore, operations to increase the level of current accounts at the Bank of Japan simply involve swapping different cash equivalents, with no impact on the liquidity of banks' balance sheets. Ito cites one study (Oda and Ueda (2005)) that found only modest evidence of an effect of the level of excess reserves on short-term interest rates, and they speculated that even this impact could be transitory. Former Bank of Japan Deputy Governor Yutaka Yamaguchi, who was one of those who initially voted to adopt quantitative easing, later expressed his view that quantitative easing had little or no impact. There is no evidence of a portfolio rebalancing effect toward risky assets, or of impacts on credit growth or inflation expectations. It is widely acknowledged that the injection of high levels of liquidity reduced the perception of financial sector risk, but it is difficult to claim much beyond this. Although the economy ultimately did recover, this appears to have been due to a recovery of exports and progress of other structural adjustments. Therefore, it seems that the BOJ was mainly lucky in terms of timing in adopting quantitative easing.

III. Recommendations for the post-QE policy framework

If quantitative easing did not work, then the BOJ has misallocated scarce resources by going to great lengths to specify the criteria for ending quantitative easing, but saying comparatively little about the conditions for ending the ZIRP, which is almost certainly a more important issue. Prof Ito notes that the BOJ's "understanding" of price stability of 0-2% for the CPI in its new policy framework could eventually evolve into a full-fledged inflation targeting framework, and this makes a lot of sense as a communication device. It also would tend to curb the bias of the BOJ against inflation. However, the BOJ shows little inclination at this stage to go beyond the present framework.

IV. Conclusions

One has to agree with Prof Ito's conclusion that the BOJ's policy during the period after 1998 was often "too little too late" and that a number of errors were made. The ending of the ZIRP in 2000 was the biggest error, and was pretty clearly a mistake ex ante as well as ex post, given that the economy was still experiencing deflation at the time, and that there was uncertainty about the outlook. The communication of the BOJ's policy goals and criteria also could have been better. In contrast, the BOJ seemed to rush too fast to exit from quantitative easing and the ZIRP. The big question is why the BOJ only adopted "weak" policy options unlikely to be very effective in a liquidity trap environment. It clearly did not regard itself as "accountable" for maintaining price stability in any strong sense. Adoption of inflation targeting could help to remedy these shortcomings.

Despite all the debate about the timing and method of quantitative easing, it is difficult, and perhaps beside the point, to evaluate these arguments in the absence of an overall assessment of the effect of this policy. This aspect needs to be explored more fully. The evidence in my opinion does not support the view that quantitative easing had a significant impact, and therefore the ending of quantitative easing is not likely to have much impact either.

References:

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