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

Masaru Yoshitomi[1]

During 1998-2005, the Bank of Japan (BOJ) conducted a historically unprecedented and extraordinary monetary policy: both the zero interest rate policy (ZIRP) and quantitative easing (QE) on top of ZIRP. In spring 1999, ZIRP was introduced but it was constrained by the so-called zero bound problem. Therefore, worsening deflation meant the real interest rate would rise, aggravating recession and hence deflation. In order to fend off this problem, QE was introduced in March 2001 on top of ZIRP, but deflation remained at between –1 and –0.6% during 2001-02 (Figure 2 in Prof Ito’s paper). Despite the continued deflation, however, the Japanese economy started to recover steadily after July-September 2002, by registering annual growth rates of 1.8%, 2.3% and 2.6% in 2003, 2004 and 2005, respectively. The Bank of Japan exited from QE in March 2006 and also terminated ZIRP in June 2006.

The objective of Prof Ito’s paper is to critically review the BOJ Board members’ discussions and decisions about policy actions taken during this fascinating period, the beginning of which almost coincided with the timing of the BOJ’s legal independence in March 1998, Prof Ito examined the timing of the introduction of ZIRP, its temporary termination (between August 2000 and March 2001) and the effectiveness of QE.

In light of the well defined objective of the paper, Prof Ito focuses on the recent history of BOJ monetary policy, and provides us with extremely useful descriptions of pros and cons debates among the Board members at the critical times of policy changes. However, his paper hardly examines the effectiveness of ZIRP or QE nor the robust recovery of the Japanese economy since mid-2002 which took place even under the deflationary environment. If accompanied by examining the effectiveness of ZIRP and QE, Prof Ito’s critical review of BOJ’s policy actions would be much more convincing and powerful. Let me give several important examples on this last point.

Prof Ito claimed that ZIRP could have been introduced by early 1995, a judgment based on the Taylor-rule simulated call rate. Furthermore, he claimed that the BOJ’s hesitation in the adoption of ZIRP was attributable to Japanese politics since the BOJ was not legally independent at that time. However, Prof Ito did not concretely explain the characteristics of the political pressure. During 1995-96, the Japanese economy recovered rather strongly, registering actual growth of about 2.5% per year. Only after the banking system crisis took place in November 1997 did the economic and political environment vastly change. Therefore, Prof Ito could strongly claim that the BOJ should rather immediately introduce ZIRP after the banking crisis which deepened a recession and hence created deflation. The BOJ did not introduce ZIRP until March 1999 because Governor Hayami held the view that deflation was not something worrisome and that ZIRP might hurt households’ interest income, as Prof Ito mentioned in the paper.

Prof Ito’s second criticism was against the BOJ’s temporary termination of ZIRP (raising the interest rate from 0% to 0.25%) between August 2000 and March 2001. While he admitted that this interest increase by 0.25% was small enough not to disturb investment or consumption, Prof Ito considered this BOJ judgment was a mistake, simply because CPI

[1] President and CRO, Research Institute of Economy, Trade and Industry (RIETI).

deflation continued and because many predicted slower economic growth in the United States and Japan due to the bursting of the ICT bubble. In this argument, Prof Ito took it for granted that ZIRP should be effective in overcoming deflation, but no theoretical or empirical evidence is provided throughout his paper.

Prof Ito's third critical review on QE, ie increases in excess reserves, appears twofold. One is that the BOJ did not adopt a non-conventional monetary policy in addition to the actually adopted purchase of long-term Japanese government bonds (JGB). The other was that the BOJ did not explicitly spell out economic conditions under which it would exit from QE, nor did it adopt inflation targeting. Here again, Prof Ito took it for granted that QE should be effective, without discussing the transmission channels whereby QE could contribute to overcoming deflation, or providing any evidence on them.

The BOJ's monetary policy mix of ZIRP and QE can be disentangled into the effectiveness of three policy instruments: (1) ZIRP per se without QE, (2) ZIRP with QE and (3) QE per se, whose effectiveness goes beyond the effectiveness of ZIRP per se. Let me briefly discuss each of them.

First, the effectiveness of ZIRP per se without QE (actually adopted in February 1999) was viewed with scepticism by many academics for the following reason. If the zero bound problem was combined with the downward spiral expectations of deflation, the interest rate would get increasingly higher in real terms, causing deeper recession and hence deflation. Indeed, the actual deflation of core CPI (excluding fresh foods only) worsened from 0% to –1% (at maximum) during early 1999- early 2002. However, no empirical evidence has been given by any academics about the downward spiral of deflation expectations. Hence, no evidence has been provided about the increasingly higher interest rate in real terms under the zero bound problem. In contrast, Hori and Shimizutani (2004) showed there were no such downward deflation expectations by the Japanese household sector, which anticipated future deflation only by less than half of the actual deflation a year ahead.

A deeper question is whether QE introduced in March 2001 contributed to such deflation-mitigating expectations, but this question can be answered only through analysing the transmission channels of QE. Two channels are conceivable. One is the straight impact of the increased excess reserves, while the other is through influencing the future course of the expectations on the short-term interest rate.

The possible transmission channel of the increased excess reserves is the impact of an increase in the monetary base on the rate of return on financial assets which are imperfect substitutes for money (unlike government short-term securities under zero interest rate). Many empirical studies indicated that the estimated impact was not statistically significant or extremely small even if statistically significant (for example, a 10 trillion (about 2% of GDP) increase in excess reserves affects only 1-4 basis points of Aa bonds (Kimura and Small, 2006)).

In contrast, increased excess reserves are found to impact on the future course of short-term interest rate expectations. The estimated impacts on flattening the yield curve are found for three- to five-year maturity bonds, and a 0.4-0.5 percentage decline at maximum on five-year bonds (Baba et al (2005), Oda and Ueda (2005), Okina and Shiratuska (2004)).

Given these rather positive impacts of QE on the medium-term yield curve, there remains an important puzzle about the actual channels through which QE contributed to the recovery of the Japanese economy from mid-2002. Actual business investment started to expand rather strongly after 2003 but such a demand effect of QE through stimulating investment has not been detected empirically. It has been suggested by many researchers that such a potential positive impact of QE was offset by balance sheet restructuring by companies which were engaged in reducing large excess debt and increasing cash flows (ie operational profits minus business investment).

Furthermore, in academic discussions of the effectiveness of QE, the definition of QE has become blurred, that is, whether QE means increases in excess reserves or high levels of excess reserves. This question arises because excess reserves stopped increasing in March 2004 at the level of about 30 trillion yen (6% of GDP) after having increased by 15 trillion yen in one year under the new Governor Fukui, who took office in March 2003, following about a 15 trillion yen increase in two years under the previous Governor Hayami (see Figure 5 in Prof Ito's paper). It remains unclear which matters: increases, or high levels of excess reserves. Another puzzle is the continued recovery and expansion of the Japanese economy during the latest few years (2004-06) even after excess reserves stopped increasing. Eventually such economic expansion contributed to reducing deflationary pressure, resulting in the exit from QE in March 2006.

Yet another related but unsettled issue is how QE actually contributed to stabilising the banking system. The resolution of this issue requires careful estimates of private banks' demand for excess reserves in the face of the possible bank run on deposits. Banks' demand for excess reserves may have changed over time, reflecting capital injection by the government in 1999, the establishment of the Financial Supervisory Agency (FSA) in 2001, the tough measures enforced by the FSA to reduce non-performing loans (NPLs) in 2003, the rescue operation of one relatively large bank, Resona, in 2004, the introduction of the ceiling on the amount of the government guaranteed deposits in 2005, etc. Only by estimating the changing demand for excess reserves will we understand how QE contributed to the stability of the banking system by allowing private financial institutions to freely dispose of excess reserves in case of deposit runs.

The last important analytical issue to be settled is the causality between deflation and recession. Many academics claimed that without overcoming deflation, recession would deepen through increasingly higher real interest rates, but the reality is that the economic recovery and expansion after mid-2002 was in fact sustained under declining public works expenditure, which was traditional Keynesian fiscal policy in Japan, and reduced deflation by narrowing the GDP gap towards zero by the end of 2005.

In sum, Prof Ito's critical review on monetary policy in Japan under deflation is very useful in deepening our understanding how the BOJ Board members actually debated and divided in opinion regarding ZIRP and QE. However, this critical review appears to be based on the presumption that both ZIRP and QE were effective in overcoming deflation and contributing to the economic recovery. Unfortunately, however, the absence of his own evaluation on the effectiveness of ZIRP and QE weakens his criticism against policy actions of the BOJ during 1998-2006.

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