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Comment on M. Fukao:

Financial Strains and the Zero Lower Bound: the Japanese Experience

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Despite its relatively short size, this is a very broad-ranging and ambitious paper. Prof. Fukao does many things: he examines the state and prospects of Japan's deflation; offers an econometric interpretation of it; overviews a number of policy prescriptions; finally, he proposes a bold and original package of measures. All this sums up to a very stimulating and useful paper. I am glad I had the opportunity to discuss it in this conference.

Fukao's diagnosis of the Japanese situation can be summarised briefly. Japan's economy is shrinking, in real and nominal terms. This process is far from being exhausted: on the contrary, according to Fukao it is accelerating. This conclusion is drawn from observing the recent dynamics of the GDP deflator (which is increasingly negative) and also from an estimated econometric model linking price dynamics to a measure of the output gap. Accelerating deflation has two consequences. First, real interest rates tend to rise, due to the zero-bound constraint on nominal ones. This exacerbates problems because it not only raises the cost of capital, but also squeezes the interest rates margins of banks (a point on which I shall return). Second, the size of the Government debt increases in relative terms. This is particularly worrisome, in view of the role fiscal policy plays in the Japanese macroeconomic strategy. A rising Government debt from the current high levels may easily generate fears of insolvency, which in turn would reduce and eventually even revert the positive effect of Japan's expansionary fiscal policy. Moreover, a sizeable depreciation of the yen (seen by many as an essential component of Japan's anti-deflationary strategy; see Svensson, 2001, and Coenen and Wieland, 2003) could as a side effect reduce the Japanese household's affection for domestic bonds, with further risks for Japanese Government debt. This conveys the impression that the room for manoeuvre available to the Japanese authorities is also shrinking, and that decisive and credible action becomes more urgent by the day.

Fukao's reasoning on all these issues is correct, in my view. One could perhaps object that certain aspects of his analysis contribute to draw an overly negative picture. For example, the recent developments in consumer prices are more favourable than those of the GDP deflator (see chart), and the former is arguably a more appropriate proxy for price deflation than the latter. But these issues are rather marginal, and do not alter the substance of the argument. Moreover, recent survey measures of price expectations confirm that, even if CPI is taken as a reference, deflationary expectations are worsening. After four years (1999-2002) in which CPI deflation outcomes have turned out to be worse that expected (measured by Consensus forecast), in 2003 the expectation have turned decisively for the worse (fig. 2). The recently published IMF World Economic Outlook (April 2003) stresses this particular point in an interesting section of Chapter 1, in which it is noted also that deflationary expectation are becoming more widespread and entrenched in the economy.

Fukao's policy prescriptions are essentially twofold. First, open market operations by the Bank of Japan should include purchases of additional assets, such as mutual fund shares and real estate

[1] The views expressed here are personal and do not necessarily reflect those of the ECB or the Eurosystem. I am grateful to Anil Kashyap and Rasmus Rüffer for useful discussion.

investment trusts. This should be accompanied by announcements indicating that the central bank will do everything needed to enact a medium term inflation objective of 1.5 percent. Second, the zero bound constraint on nominal interest rates should be removed by introducing a tax on currency (echoing the so-called Gesell Tax discussed by Keynes in the General Theory).

I agree with the idea that enhanced open market policy and proactive central bank announcements are a necessary component of any successful policy package for Japan. However, I doubt they can be really effective, unless supported by other conditions. We know from theory (from Keynes himself) that open market operations are ineffective at very low interest rate levels, because investors are willing to absorb unlimited amount of liquidity. Japanese data for the last 2 years, reported in Fukao's paper, showing astronomical expansions of the money base in the midst of continuing deflation, are a painful illustration that that theory is valid. Extending the range of assets being purchased by the central bank would not necessarily help, unless the central bank was prepared to buy so much of those other assets (like e.g. real estate) to have a significant effect on their price (something I regard as doubtful). Moreover, central bank announcements of any given inflation rate would not necessarily be credible, in the absence of adequate instruments to enact that inflation rate. This objection applies to Fukao's paper as well as to other suggestions for central bank inflation announcements, formulated by Krugman (1998) and others. To break this vicious mix of policy ineffectiveness and lack of credibility, a combination of domestic and external conditions seems necessary.

I have rather serious reservations concerning the proposal for a Gesell-type tax. Such a tax would require the introduction of a new currency and a banknote stamping procedure, both measures administratively complex and burdensome. One should not forget that the tax would have a direct deflationary impact, like any tax. There is also a risk that, being a rather extreme and unconventional measure, it could negatively affect consumer confidence and increase precautionary savings. These side effects and risks must be carefully weighted against the potential benefits, which are uncertain.

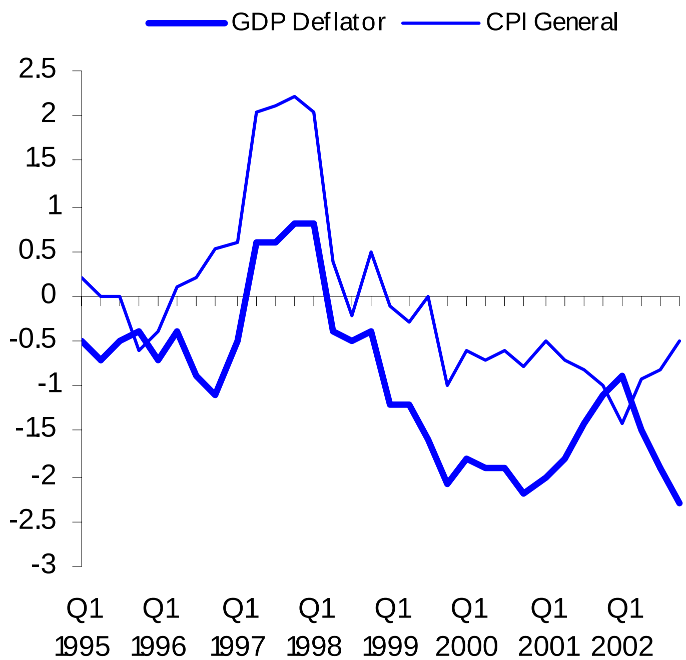
Even if effective in removing the zero bound constraint, I am not convinced that such a tax would contribute positively to the viability of the banking system. Fukao's data on the Japanese banks' profit and loss situation (table 2 of the paper) show that lending margins and gross profits of Japanese banks have not decreased significantly in the last 15 years. The problem is concentrated in the loan loss component, which sharply deteriorated in the second part of the 1990s. The real issue in Japanese banking is that of the quality of credit. Minor adjustments in the margin between deposit and lending rates, such as the ones that a Gesell tax could bring about, would do nothing to cure this problem.

The paper does not, in my view, address or put sufficient emphasis on the structural problems of the Japanese financial system. Observers have recently noted that not only the quality of bank lending, but also that of the banks credit screening practices are far from showing signs of improvement. In a Wall Street Journal article, Kashyap (2002a) recently characterised the situation as one in which "bankrupt banks continue to lend to bankrupt firms" (see also a related working paper, Kashyap, 2002b). If this is the situation, it seems clear to me that the most urgent problems are of structural nature, and macro-monetary measures can at best have a supporting role.

I am convinced that the solution of Japan's *malaise* will come from a combination of factors acting together, not from a single decisive measure or event. Continuing expansionary monetary and fiscal policies, exchange rate depreciation – in the context of a more favourable international environment – will have to be accompanied by supply side improvements stemming from corporate restructuring and more transparent and objective credit screening procedures by banks. The mix of these components will eventually work, though progress may not be as rapid as one would hope. A further ingredient of the appropriate policy mix for Japan is likely to be patience.

Japan: Price Indices

(year-on-year percentage change)



Source: Financial Thomson Datastream, Cabinet Office

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