

Japan's Macroeconomic Policy Experience pre-1990

Lecture III

Trinity Term 2004

Economies of the OECD Countries

Additional Reading

Ito, 1992, Chap 4.

Flath, 2000, Chap 6.

Patrick, Hugh and Henry Rosovsky (eds), (1976) **Asia's New Giant: How the Japanese Economy Works**, Brookings pp 14 -43. (out of print but still in libraries)

Cargill, Hutchison and Ito, (1997) **The Political Economy of Monetary Policy in Japan**, MIT Press, Chap 3.

Thinking About Macroeconomic Policy Issues

- ◆ policy goals or objectives:
 - basically short to medium term
 - unemployment, inflation, growth, stability, (balance of payments, exchange rates?)
- ◆ But prolonged short run deviations from optimum may have long run effects: hysteresis

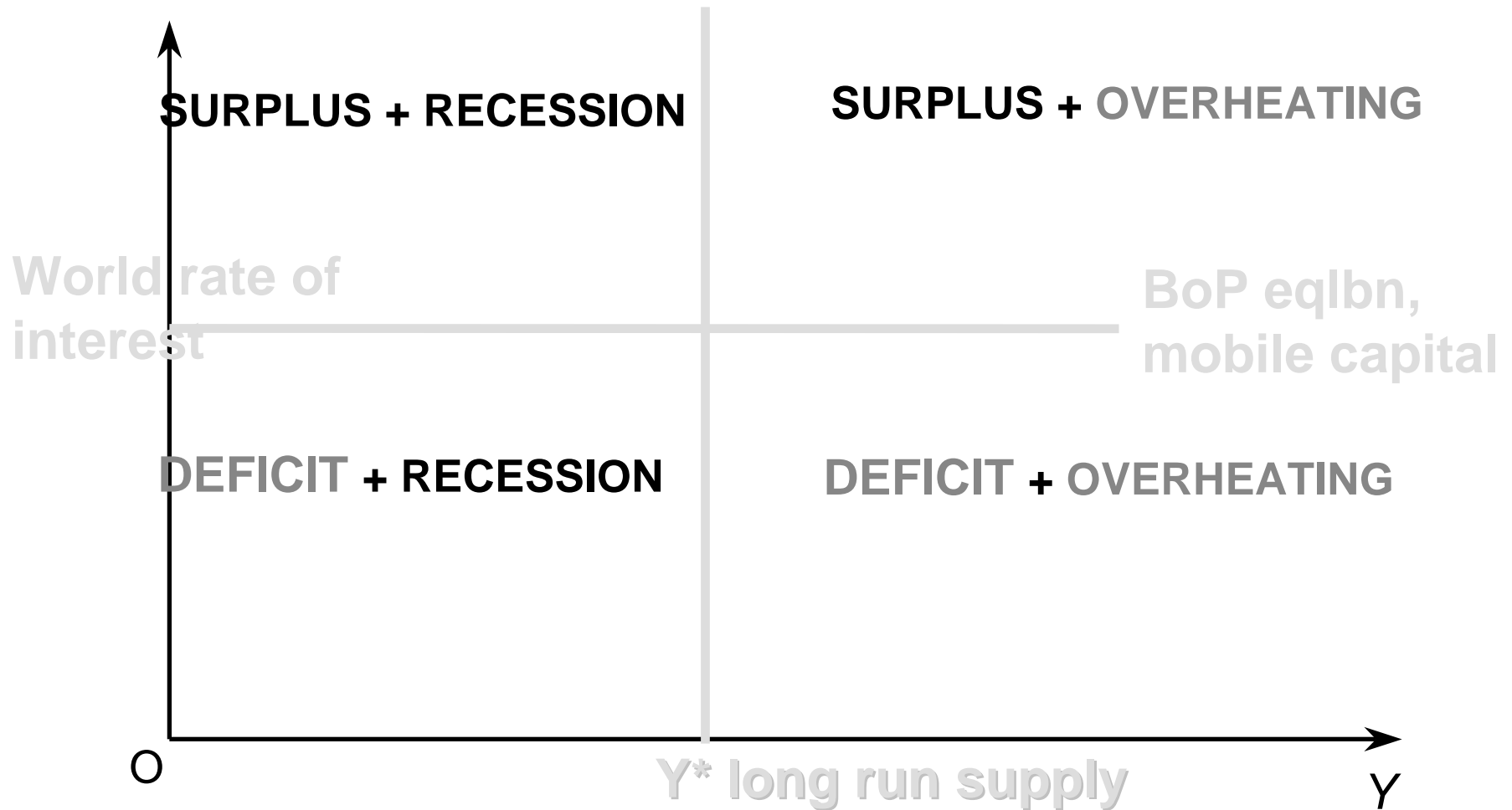
Thinking About Macroeconomic Policy Issues

- ◆ constrained optimisation
 - fixed vs flexible exchange rates
 - international capital controls vs open markets
 - existing (inherited?) size of govt debt
 - constitutional/legal restrictions e.g. central bank independence

Periods in Japan

- ◆ Differing goals, instruments and constraints at different times
 - Reconstruction period: growth dominated inflation; external trade and capital controls; fixed exchange rates
 - High growth: balance of payments constraints
 - Adjusting to success (late 1960s to 1973) – inflation matters
 - Lower growth, higher inflation: 1974 to 1979 (OPEC I and II): credible anti-inflation policy
 - Bubble years (1980s); post OPEC II recovery, international policy coordination and “managed” exchange rates
 - Recession of 1990s: lost direction, (was growth a priority?), full open-economy macro problems.

Open-economy, fixed exchange rate : policy trade-offs



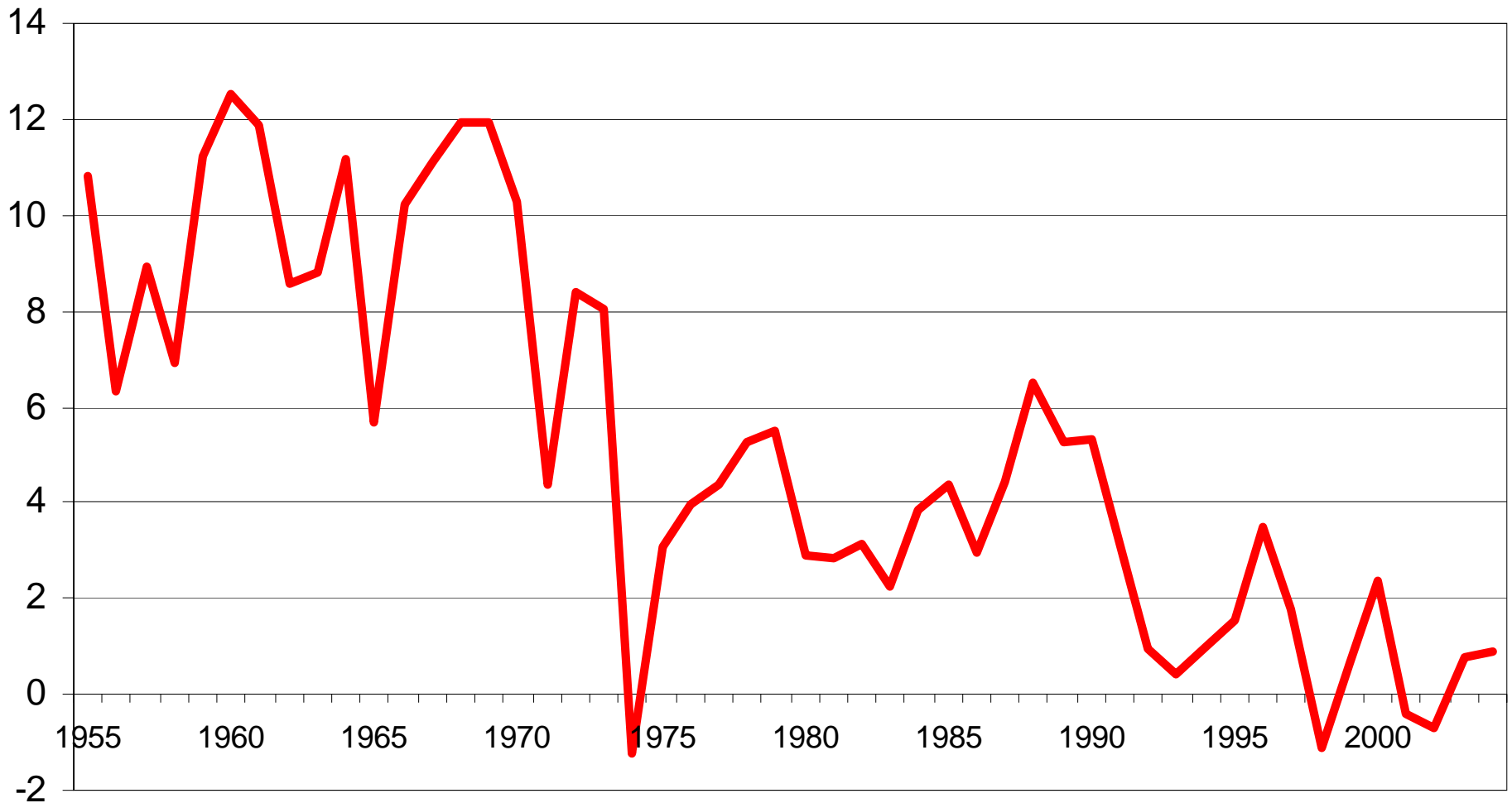
Open Economy Macro Policy with International Capital Mobility

Exogenous Change	Effect on Real GDP	
	Flexible Exchange rates	Fixed Exchange rates
Expans. Fiscal	No effect	Powerful effect
Expans. Monetary	Increased effect	No effect

Issues

- ◆ How effective has stabilization policy been in Japan?
- ◆ What's distinctive about Japanese monetary and fiscal policy?

Japan's GDP Growth Rate (% pa)



Policy effectiveness and business cycles

- ◆ Did policy smooth business cycles?
- ◆ Data show
 - Japan is less volatile postwar than prewar
 - But the difference is less marked than in US
 - During HEGP Japan was less volatile than US (UK, Germany)
 - Post OPEC I volatility was much lower
 - That is, the business cycle has not been so severe in Japan and has been getting smoother.
 - In 1990s recession is also smooth.

Average Growth Rates, Standard Deviations and Coefficient of Variation

	AVERAGES				STANDARD DEVIATIONS			
Country	Japan	USA	UK	Major 7	Japan	USA	UK	Major 7
1961-1974	8.66	3.97	2.83	4.66	2.37	1.92	1.13	1.01
1975-1990	4.07	2.92	2.21	2.94	1.08	2.30	2.08	1.61
1975-1995	3.44	2.68	1.97	2.67	1.58	2.18	2.13	1.52
	COEFFICIENT OF VARIATION							
1961-1974	0.25	0.46	0.40	0.21				
1975-1990	0.27	0.79	0.94	0.55				
1975-1995	0.46	0.81	1.08	0.57				

What causes smoother cycles?

◆ Either:

- successful countercyclical stabilization policy
- or industrial structure changed to more diversified and robust one
- or external shocks were smaller

◆ Evidence :

- less volatility in Investment, diversification into services, JIT manufacturing all smooth cycle
- Monetary policy, but not fiscal, steadier after 1975
- So mix of policy and structure

Distinctive features of monetary policy

- ◆ Was major instrument of stabilisation policy to 1975
- ◆ Tools included: BoJ discount rate, BoJ lending to private banks, call money interest rate, window guidance (not OMO)
- ◆ Credit channel main **transmission** mechanism until 1970s (maybe later?)

Operation of Monetary Policy from 1970s

- ◆ *Targets* were BoP stabilisation up to 1969, domestic inflation afterwards
- ◆ *Instrument* changed in 1975 to money supply rule (first to use it)
- ◆ Distinctive features of financial system (bank-centred, overborrowed) enhanced control of policy
- ◆ 1998 BoJ became independent
 - both goal **and** operational independence

Debates about Monetary Policy

- ◆ Was it destabilizing rather than stabilizing?
- ◆ Was it ever successful as stimulus policy or only as deflationary tool? (probably only as deflation)
- ◆ How much did monetary policy mistakes contribute to inflation after OPEC I?
- ◆ Was monetary policy of 1975-89 monetarist?
- ◆ Was policy 1985-89 responsible for asset price bubble?
- ◆ Did policy of 1990-91 burst the asset bubble?
- ◆ Did later policy errors cause the recessions of the 1990s?

Distinctive Features of Fiscal Policy

- ◆ Divided into 3 govt accounts (Size depends on which account you measure)
- ◆ Dodge Line imposed balanced budgets up to mid-70s
- ◆ Apparently no stabilisation role for fiscal policy
- ◆ major change in use of fiscal policy in recession of 1974-75 (first deficit financing bonds and rapid expansion of govt expenditure)
- ◆ Why?
 - underestimated the fall in potential growth, trying to get back to pre 1973 levels
 - social security benefits increased (and inflation indexed)
 - MOF hoped for intro of indirect taxes, over-estimated revenue

Sectoral Balances in Japan (% of GDP)

	1960– 73	1974– 90	1991– 99	1960– 99	1999– 2001
Gross domestic savings	36.1	32.1	30.5	33.1	27.8
Gross domestic investment	35.4	30.8	27.8	30.9	26.3
General government net lending	1.0	–1.9	–2.7	–1.1	–7.2
Private sector balance	–0.3	3.2	5.4	2.3	9.5
Foreign balance	0.7	1.3	1.7	1.2	2.3

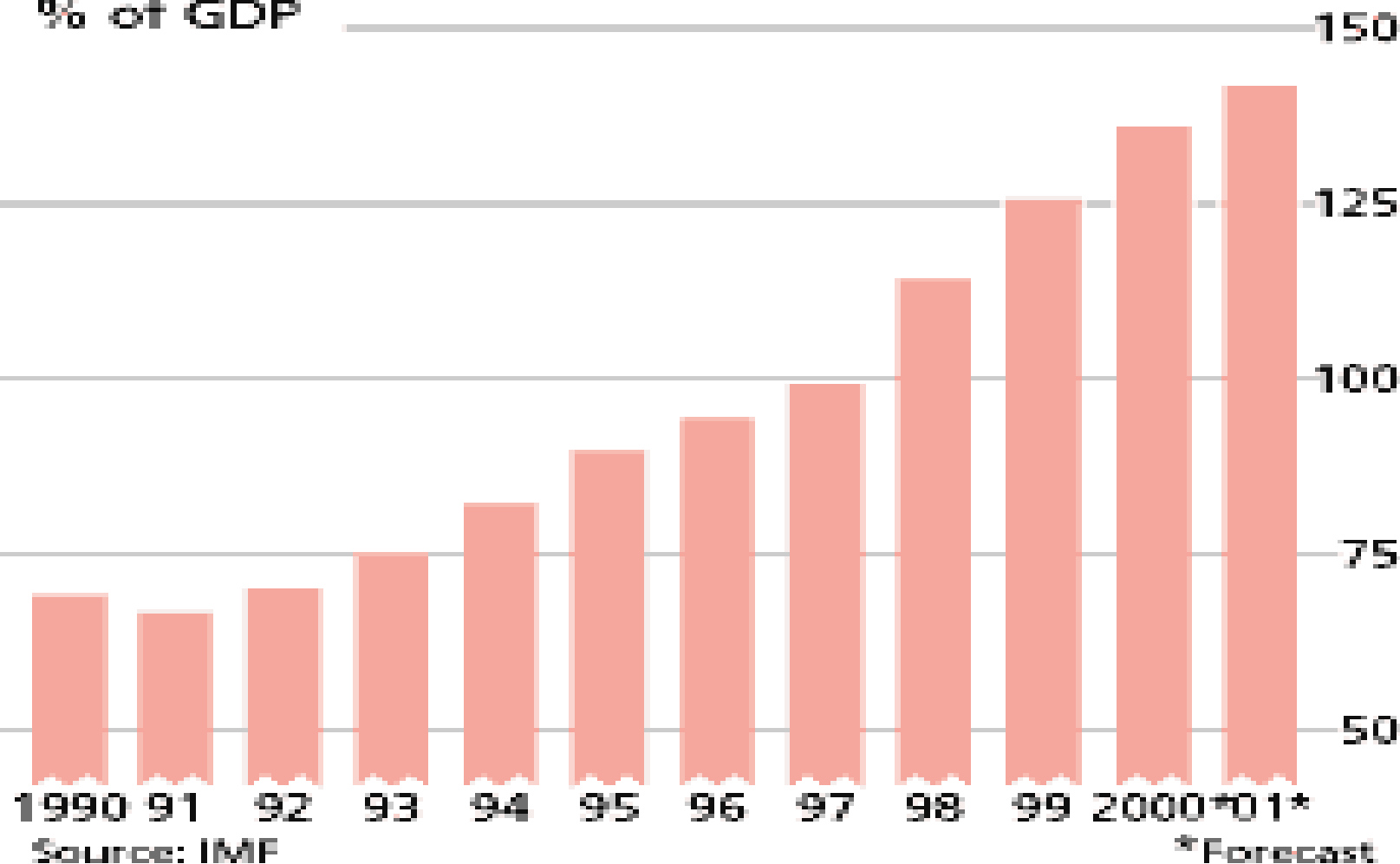
- ◆ Source: OECD National Accounts of OECD Countries, Historical Statistics and Economic Outlook (various issues)

Debates about Fiscal Policy?

- ◆ Does private sector offset changes in government spending and taxation?
 - may get “crowding out” of investment
 - may get consumption reductions in anticipation of future tax burdens (Ricardian equivalence)
 - Evidence is ambiguous but “eyeball” test suggest not. (Fiscal policy has worked since 1975)
- ◆ From 1980s MoF worried about levels of debt
 - are they sustainable?

An Olympian achievement

Japan's gross general-government debt as % of GDP



Source: Economist, Sept 30, 2000

Conclusions

- ◆ A number of features of monetary and fiscal policy are different in Japan
- ◆ Relative macro stability and “success” of policy post OPECII has generated international interest
- ◆ Monetary policy has made mistakes (1971-74) (1985-91) and has mostly been used to **create** downturns after overheating is detected.
- ◆ Important changes in the *targets* and *instruments* of monetary policy.
- ◆ Credibility and independence of Bank of Japan may have negative as well as positive effects.

-
- ◆ Conventional fiscal policy was not used actively until 1975 (though FILP spending was countercyclical)
 - ◆ Fiscal expansions have generally worked to promote recovery from recessions but have created a debt “problem”.

Additional Reading: The Bubble Years

- ◆ Cargill, Hutchison and Ito, 1997, *The Political Economy of Monetary Policy in Japan*, MIT Press (particularly chap 3)
- ◆ Ishi, H. 2000, *Japan's Tax System*, OUP (particularly chapter 1)
- ◆ Kernell, S. 1991, *Parallel Politics: Economic Policymaking in the United States and Japan*, Brookings Institution (chapters on budget policy, Noguchi; tax reform, Muramatsu & Mabuchi; structural policy, Shimada)
- ◆ Krugman, P, It's Baaack, BPEA.
- ◆ Noguchi and Yamamura, 1996, *US-Japan Macroeconomic Relations: Interactions and Interdependence in the 1980s*, U of Washington (chapters by N and Y on political economy of the bubble)