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The Current State of the Japanese Economy: A Macro-Economist's View

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I am quite concerned with current Japanese macro-economic policies that seem to contradict sound principles of economics. These short essays are designed for English reading audiences, in order to enable them to consider a different perspective. While these essays are actually "companion" pieces, each can be read as a "stand alone" essay. I thank the NIRA (National Institute for Research Advancement), its Chairman, Jiro Ushio, and its Director of Research, Reiko Kanda for giving this valuable opportunity to post them[1].

Table of Contents:

[1] This paper contains an English version of three notes in Japanese, "*Fuan wo Kaisho sureba nihon keizai nohinodemo tokunai* (The Sun Goddess will rise again if we suppress the anxieties)." Weekly Ekonomisuto, May5-12, 2009; "*Kin-yu Zaisei no yori Chowa no Toreta seisaku Un-ei.wo* (Towards a more balanced mix of monetary and fiscal policies)" NIRA Policy Review, No.40, July, 2009.; and "*Nichigin wa Sangyoukai wo Kurushimeteiru* (The Bank of Japan makes industries suffer)." Boisu (The Voice). September, 2009. I thank the editors of these Reviews for allowing me to use parts of my articles. I owe Yasushi Okada of the Japan Cabinet Office for his discussions and for his collaboration in drawing Figures below.

<Essay I>

The Sub-Prime Crisis from Both Sides of the Pacific: A Modern Aesop Fable

> "Once upon a time, on the East side of the Pacific, there was Country A that was inhabited by grasshoppers; on the West side of the Pacific, there was Country B that was inhabited by ants.
>
> Grasshoppers in Country A lived a high style of life because they had a secret bottle called "the cruse of Wall Street," which was allegedly able to transform, by magic, risky real estate securities into a set of safe securities. Someone could put into the cruse, papers that were contaminated with dirt, and miraculously receive gilt-edged securities in return. The transformed, gilt-edged securities were labeled "sub-prime securities." In this manner, grasshoppers could afford to enjoy presumptuous consumption beyond their means by borrowing from Country B.
>
> On the other side, ants in Country B worked hard to leave estates to their off spring. They were so pressed to increase their savings that they even bought the securities produced by the magic financial engineering.
>
> Suddenly, it was discovered that the magic of the Wall Street cruse was a fake. The processed securities, once appearing as gilt-edged turned out to be edged with dirt. Moreover, all those securities were labeled as AAA securities, and there was no way to distinguish securities that contained risky elements of default (landmines) and those that were free of them.
>
> What could grasshoppers do under these circumstances? And furthermore, what could ants do?

I-1: Introduction

This is a metaphorical picture of the current state of the sub-prime crisis. In the United States, a country of grasshoppers, the wealth that they thought they possessed has disappeared suddenly. The loss in the value of their assets requires adjustment in consumption. The most probable adjustment to this decline in permanent income is to reduce consumption and improve the current account balance of payments while reconstructing the financial system.

This change means that Country B, the ants, which may be represented by China or Japan, will also be seriously affected. If the U.S citizens suddenly reduce spending, then exports from China or Japan will substantially decrease. Through this process, China or Japan will share some of the burden that the U. S. economy imposed through the misperception of risks and returns in real estate loans. As in the case of Japan before her lost decade in the 1990s, the myth of ever rising real estate prices reinforced this misperception. Genuinely risky assets were regarded safe because of the ever rising real estate prices.

China and Japan have long accumulated their foreign assets in the form of dollar denominated securities. Because of the predetermined accumulation of the dollar denominated securities (some economists call “the original sin,” whether appropriate or not), both the Chinese and the Japanese people have ended up in a capital loss situation. For example, China is reluctant to appreciate the Yuan, even if appreciating the Yuan is the right solution for coping with the inflationary pressure in China (conflicted virtue).

As is indicated by the fable, not only the aspect of asymmetric information in finance but also the difference between the degree of time patience in U.S. and that in Japan or China was in the background of chronicle imbalance in the balance of payments.

I-2: Volatile Asset Prices in the U.S. are Triggers for World Turmoil.

It was difficult to blame other countries when Japan was in its lost decade during the 1990s. Japan’s problem started from its own. Some in Japan attributed the cause of deflation to low commodity prices exported from China and other countries, but that was wrong because Japan could chose more depreciated yen rates. The sub-prime crisis, on the other hand, began in the United States, while the Japanese and Chinese systems were functioning normally. *Fundamentals in these neighboring countries were practically sound* when the crisis started, except that they invested into the financial assets in the United States. This crisis is an imported crisis from the United States to Japan, China and other Asian nations. The malfunctioning of the United States market and the mishandling of the crisis by the U.S. government worsened the situation, and foreign trade partners now have to deal with the consequences of the U.S turmoil. In the stock dimension, the epicenter of the earthquake was in the United States, and its waves were immediately transmitted to foreign asset markets as well as to the currency market. The sudden disruptions in the asset markets in foreign countries caused declines in the flow dimension, such as their exports, output, and finally in the labor market.

Stock markets are aligned because capital can move freely around the world. This integration usually adds to the capability or dynamic efficiency in allocating consumption and investment around the world. On the other hand, huge capital movements are triggered by arbitrage possibilities with a very small margin of rate differentials, and the possibility of emerging bubbles becomes reality.

Therefore, the present difficulties were not so much caused by structural problems in Japan's domestic markets as by triggers from the U.S. financial market. Price movements in the stock market (assets) are abrupt and extremely volatile, while those in the flow market are slow. Interactions of immediate movements in the market of stock variables and slow movements in the market of flow variables create interesting but serious adjustment problems.

I-3: Scenes in the U.S. in the Center under the Sub-prime Crisis.

Let me compare the scenes in the United States where I regularly live, to the scenes in Japan where I occasionally stay.

First, securitization has advanced in the United States. In Japan, university teachers' pension funds do not invest in equities, but in the United States a part of college teachers' pensions funds (CREF) invests in equities. Accordingly, as an aspiring retiree in a few years, I was alarmed when my wife watched the sudden reduction of my retirement capital as the total (fictitious) wealth of Lehman Brothers disappeared. The development of the sub-prime market had been beneficial to low income house holders. It was an erroneous belief, however, that mixing and manipulating these risky loans by financial engineering could craft derived assets with safer and much higher returns.

Second, worship on Wall Street remains strong. Many Yale students still favor applying to financial sector jobs. In spite of the fact that firms are to receive government "help," that is, Federal tax money, chief executives do not find it awkward to fly to Washington D.C. in private jets, nor do they consider it inappropriate to also pay large bonuses to executives. Those privileges are entitlements as well as rewards to winners of tournament competition. What a vastly different scene it is from the one in Japan where chief executives bow deeply to tax payers as apology!

Third, in a parallel way, the trust in financial markets has been, and is now, strong. Any dynamic optimization course begins with the assumption that the agents observe the non-Ponzi-game condition. In Japan the pyramiding scheme is called *nezumi-ko,* a "multiplying" scheme.

I-4: Scenes from Japan Where Fires Were Thrown from Abroad

Whenever I return to Japan, I am impressed that Japan is full of consideration for old, sick, and disabled people. Under this spirit of warmness, or sometimes conceited warmness, and under the electoral system that magnifies the voting power of residents in rural areas, public expenditures were distributed to rural areas during the long reign of the Liberal Democratic Party (LDP). The new incumbent Democratic Party of Japan (DPJ) will be likely to reinforce this trend. In each city, the local government has built an art museum, concert hall, and recreation facility independently. Roads go deep into forests and the bullet train runs without passengers close to capacity except during the times of vacation periods throughout the country. I used to accept these amenities as luxuries rather than inefficiencies. I felt that the Japanese were lucky to be able to afford these luxuries thanks to the remarkable high growth period during 1960-1980.

In the area of health care, for example, goodwill is extended to those who have low or little income. On the other hand, from my personal experiences as a patient in the two countries, medical care in Japan seems to incur such system costs as uniform treatments for similar illnesses, longer waiting time of patients, and excessive use of prescription of drugs. Nevertheless, it is a great merit of the Japanese system that virtually a hundred percent of residents are covered by the solid medical insurance.

I-5: Transitory Remarks to the Next Essay

Because of this remaining cooperative nature of the society, the policy discussions about the present crisis were super-imposed on the "social" policy agenda. The discussions are focused on how to use (in terms of flow variables) public expenditures for various social and economic objectives to benefit citizens. They emerge from good intentions, but would the present crisis, occurring once in 80 years, allow us to divert our attention from the crucial issues that are directly caused by the linkage to the international capital market, that is, the issues in the asset markets and monetary policy? This will be the main theme of the next essay.

<Essay II>

The Flight of Japanese Macroeconomic Policies on one Engine: Fiscal Stimulus without Monetary Stimulus

Koichi Hamada, Yale University

II-1: Introduction

In the macroeconomic policy debates in Japan, we see an emphasis on fiscal-policy such as tax reductions, rebates and government expenditures on public works. On the other hand, we see very limited discussions on the role of monetary policy that is directly applicable to the asset disequilibrium and its corrections - corrections that are essential to coping with the current crisis.

Reflecting upon the cooperative, or “warm” you may say, nature of the Japanese society, the policy discussions on the present crisis were dominated by the policy agenda for social objectives. The discussions centered on how to use (in terms of flow variables) public expenditures on various social and economic objectives for the benefit of its citizens. In general, Japanese policy authorities and media emphasize the fiscal economic stimulus in terms of flow. The general equilibrium aspect of macroeconomic policies is neglected. Japanese scholars in macroeconomics tend to neglect the role of monetary policy that deals with shocks in asset market from abroad as in the current case of sub-prime problems.

II-2: Why Is the Monetary Side of Macroeconomic Policy Relatively Neglected?

There are conceivably several reasons in the background of this tendency. First, still “old guard” economists remember the textbook Keynesian assertion that monetary policy is much less effective than fiscal stimuli. Second, modern macroeconomics along the lines of real business cycle theory builds a world where at equilibrium, real factors drive almost an entire universe and monetary factors play a minimum role for economic fluctuations. The proponents of the real business cycle theory seem to stick to this paradigm even in the current situation where sources of trouble come from disequilibria particularly in asset markets.

Third, though it is just my conjecture, economists seem to be bound by the administrative guidance of the Bank of Japan (BOJ). The BOJ naturally encourages scholars who advocate opinions conforming to the BOJ, and discourages those who criticize them by selections of appointments to its research positions, invitations to its conferences, or granting financial support. The BOJ plays a large part in financial studies in Japan. Its administrative positions such as being a member of the Policy Board of the BOJ (including Deputy Governor) that are open to scholars, are such attractions that scholars who are prospective Board members seem to be strongly discouraged from expressing critical opinions about the BOJ policy.

In fact, the number of scholars in their prime in Japan who discuss the effects of monetary policy even in general is very small. The hesitation of economists to questioning the BOJ's position may be a natural reaction, but this type of attitude may endanger the national welfare by allowing the economy to endure the continuing yen appreciation and price deflation.

II-3: Why Is Monetary Policy Effective in Coping with the Crisis?

Kaoru Yosano, the Finance Minister of the (former) LDP cabinet, often used to say, "The BOJ is very helpful." According to him, the BOJ tries hard to enhance economic activities by purchasing wider securities like long-term public bonds. Was the BOJ really helpful? Yasuyuki Iida of Komazawa University painstakingly classified and analyzed the statistics published by the BOJ and found that most of the public bonds that the BOJ actually bought were long term government bonds that had approached their maturity during 2002-06. In other words, the BOJ was buying public bonds that already functionally became short term bonds though it pretended to have bought substantial long term bonds[2].

This sort of deception was in the back ground of the dialogues between Minister Yosano and Paul Krugman of Princeton University. To the statement by Yosano, "The BOJ is more helpful than we expect," Krugman replies that much more could be done with monetary policy. He even alarmed that, without necessary policies, the Japanese economy would repeat "five or ten years of the lost decade." (These statements were re-

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[2] http://d.hatena.ne.jp/Yasuyuki-iida/00090531#p1.

translated from the Japanese version of Krugman's comments on television [*Shinnhodo* 2001], broadcasted on May 24, 2009 by *Fuji-TV*.[3])

II-4: Need for Emergency Rescues in the Crisis

The main feature of financial turmoil is that the declines in asset prices incapacitated the real estate market, the credit market and the bank loan market. Proper functioning of the credit market, the bank loan market and the mortgage market all affect the nature of public goods, and disorders in these markets disturb seriously the systemic functions of national economies. At this kind of critical moment, policy makers should give priority to the *emergency rescue* policies developed to deal with systemic destructions in those crucial markets rather than to the policies to improve economic structures and the long-term welfare of people. One has to sharply distinguish between the emergency policies that should be immediately enacted to rescue the financial fiasco, and those policies needed to improve the quality of people's lives immediately or in the long run.

Of course, some of those immediate policies may have undesirable side effects in the long run. Future generations may suffer from these emergency measures of tax reductions and construction spending. Monetary policy that directly works on asset markets may also have side effects that lead to inflation. In Japan, even more than in the United States, however, the economy is under deflation rather than under inflation, and accordingly, the risk of inflation is not serious. Worrying about inflation at the period when unemployment excess capacity is historically high is, as Krugman puts it, "to worry about fire at the time of flood.[4]"

II-5: Limitations of the Fiscal Stimulus

Under flexible exchange rates, a fiscal stimulus that is unaccompanied by a monetary stimulus has only limited effects on the effective demand. The increase in real interest rates that occurs with fiscal expenditure will decrease the export demand and that will offset the domestic demand through fiscal expenditures. This Mundell-Fleming effect

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3 This part is not based on the exact quotes of what Krugman said in the television but on the retranslation of what was broadcasted in Japanese, because I have been unable to obtain the English transcript of the program.

4 Or retrospectively, the BOJ tries to avoid any substantial monetary expansion. A Japanese proverb says, "One blows the salad after hot soup."

will resurrect as well when the Keynesian framework revives because of the price-wage rigidity.

Next, government expenditures have problems, as economists echoed in the wave of criticisms of the naïve Keynesian prescription. Future generations may suffer because of the aggressive fiscal expansion because it increases their future tax liability. This Neo-Ricardian effect is empirically observable in Japan.

The unfortunate feature of the present crisis is that because of the absence of a monetary policy, the government relies solely on the adoption of otherwise undesirable fiscal policies to guarantee the survival of the system. We have to close our eyes to the undesirable side effects of fiscal policies in order not to rock the boat we are all on now.

In the United States, Japan, and in any democratic countries, politicians are looking for votes and popular support. Therefore, it is the instinct of politicians to mix medium term policy goals in their political agendas with the device for handling the impeding crisis. We always need structural policies that enhance the quality of life. In this current situation, however, it is imperative to save the credit system from immediate threat. After the system survives and revives, then it will be easier to achieve social and political goals and to achieve a more balanced government budget.

In the epicenter of the sub-prime crisis, the United States policy measures in almost all categories are attempted. Not only policies concerning the flows, that is, spending policies of the government but also various policies that act on the asset markets are put into effect. In other words, both income maintenance policies in the flow markets and price maintenance policies in the asset markets are attempted.

In Japan, the latter, asset-price oriented policies are almost neglected, perhaps because of the ignorance of politicians and the public about the relationship between asset markets and flows markets. They are limiting their attention to fiscal policies as a means of emergency measure without utilizing the role of monetary and asset management policies.

II-6: A Flight with a Single Engine and the Need for Unconventional Monetary Policies

The open market (buying) operation is the conventional instrument for monetary expansion. Under the zero interest situation or the near zero interest situation, which prevailed in Japan for a substantial period, the conventional market operation lost its edge because government short-term securities are almost perfect substitutes for cash. This is the reason for the fact that unconventional policies were adopted to rescue the Japanese economy from the lost decade. For example, the Bank of Japan (BOJ) attempted to buy a certain amount of common stocks, and the Ministry of Finance (MOF) engaged in the huge exchange intervention, called the "Great Intervention" by John Taylor. In short, in order to be effective, the Central Bank or the Ministry of Finance should buy securities that have return-risk characteristics farther away from the return-risk characteristics of money.

If the BOJ purchases government bonds, then they should accordingly be medium term or long term government bonds. The BOJ takes a careful attitude concerning the widening of the targets of the open market operation.

It is, however, solely the BOJ that can influence the asset markets and support asset prices by private equities and currencies without reducing the supply of money. According to the institutional arrangement in Japan, even the MOF cannot engage in such operations without borrowing money from the BOJ or without raising tax revenues. Only the BOJ can engage in meaningful buying operations of equities and debentures.

Unconventional operations beyond short term government securities may lead to side effects[5] and excessive liquidity in the long time future. Thus it is understandable that the BOJ tends to be "careful and conservative." If the central bankers' attitudes move from "cowardly," however, they may generate such a tragic situation that Japan's financial market is still in flames even though the fire in the epicenter, the United States, has been extinguished. The buying operations in unconventional bonds and securities by the BOJ or even the suggestion of such a possibility will help to bolster expectations such that the securities market may rebound soon.

II-7: Concluding Remarks; Where Does Macroeconomics Go Ahead?

[5] For example, the question arises, for fairness, what company's equities or bonds should the central bank to purchase?

In this essay, I observed the asymmetric nature of Japan's policy mix. Such an over-reliance on the fiscal instruments is ineffective particularly under the floating rate without the help of monetary expansion. The Neo-Ricardian effect will diminish the power of expenditure policies as well. The Bank of Japan is reluctant to expand monetary policy - worrying about the possibility of financial disruption and inflation in the long, long time ahead. It is even more pitiable for the Japanese economy that Ministers and their advisers do not understand the relationship between asset markets and flow markets.

The relationship between asset equilibrium and flow or goods equilibrium has been seriously studied by great economists such as Knut Wicksell, John Maynard Keynes, Milton Friedman and James Tobin. In his general equilibrium world of asset markets and their interactions flow markets, Tobin compared the price of a unit of equity with the (unit) reproduction cost of the firm, calling their ration "q." When Tobin's q is above unity, there is an incentive to invest in the firm. He pays crucial attention to the relationship between the stock price and reproduction costs. The current crisis emerged from the discrepancy between volatile asset prices and sluggish flow prices.

The rational expectations revolution made important contributions in macroeconomics by introducing forward-looking agents and pursuing rationality of behavior and expectations formation. With the advent of the Real Business Cycle (RBC) theory, however, macroeconomics now essentially focuses on the situation where frictions between stock prices and flow prices are minimized. The study is concentrated on the world where "q" is automatically unity. Such a world is the juxtaposition of the world that we observed in and after the sub-prime crisis.[6] The excuse of a traditional economist I overheard is that this situation is such an extremely rare situation that the basic ingredients of the eclectic New Keynesian will be unaffected.

Can we expect emergence of a new macroeconomics theory that emphasizes the disequilibrium process by itself, exhibits betrayed expectations, and discusses seriously

[6]Presumably, the new Keynesian economics should be able to cope with this situation because it contains many Keynesian elements, such as price-wage inertia, limited rationality and others. But most of the New Keynesian models are strongly bound by the spell of the long run neutrality of money, the classical assumption, models often look like entities that try to deviate but return to the palm of the Buddha, a neoclassical god.

the divergence between the asset prices and the flow prices? Or, after the storm, will the traditional school revive to glorify the flow markets with some cosmetic surgeries and dominate the academic scene?

<Essay III>

A Nightingale Who Does Not Sing:
The Bank of Japan Pursuing Systemic Stability Without a Monetary Policy

(Koichi Hamada)

III-1: Introduction:

The world economy under the sub-prime crisis is in the midst of financial turmoil. Japan was fortunately not the epicenter of the world crisis, but the Japanese economy experienced a deeper trough in production than the United States, the United Kingdom or the Euro area.

Employing macroeconomic policies, governments are trying to counter these unprecedented disturbances. In different countries the policy measures take different forms. Everyone's life is seriously affected.

In the first two essays, I pointed out the asymmetric, single lung so to speak, emphasis on fiscal instruments relative to monetary instruments in Japan. In this essay, I will examine the stance of monetary policy and its possible impact on the current recession in Japan.

III-2: Differences in Monetary Policies and Their Impacts on Major Countries (or Regions)

The Federal Reserve Board (FRB) as well as the Bank of England (BOE) instituted an extremely expansionary monetary policy after the onset of the crisis. The Bank of Japan (BOJ), however, continued to navigate the course with a rather austere monetary policy. The yen exchange rate soared and all Japanese industries had to cope with the hurdles of export as well as import competition. People the world over have been affected by those macroeconomic policies.

The graphs (constructed in collaboration with Yasushi Okada) in the enclosed charts on global monetary experiences after the sub-prime crisis will illustrate a case in point. At a time, the level of nominal interest rate was considered to be the appropriate measure of monetary tightness or easiness, but under the zero interest rate that prevailed in Japan, the nominal interest rate tells only a little. The U. S. and the U. K. also plunged into the zero interest state so that the quantity measures should be counted.

In the following we measure the degree of monetary easiness by the magnitude of the Central Bank’s assets. The first graph contrasts the expansionary monetary policies of the FRB and the BOE with the extremely conservative one of the BOJ (Figure 1). Mainly because of these differences, within a half year after Lehman Brother’s epic fall, the real exchange rate of the yen appreciated more than 20% (Figure 2). The Japanese call it “the single flight of the yen.” Both export and import competing sectors in Japan faced higher hurdles of the appreciated yen. Industrial production in Japan fell close to 40 % from its peak as compared with the 10% fall of the U.S. industrial production (Figure 3).

According to the Index of Industrial Production (IIP), more than a third of the productive capacity that had been available in the beginning of 2008 was idle in 2009. With the newest figure, a quarter of the factories are still inactive!

Figure 1

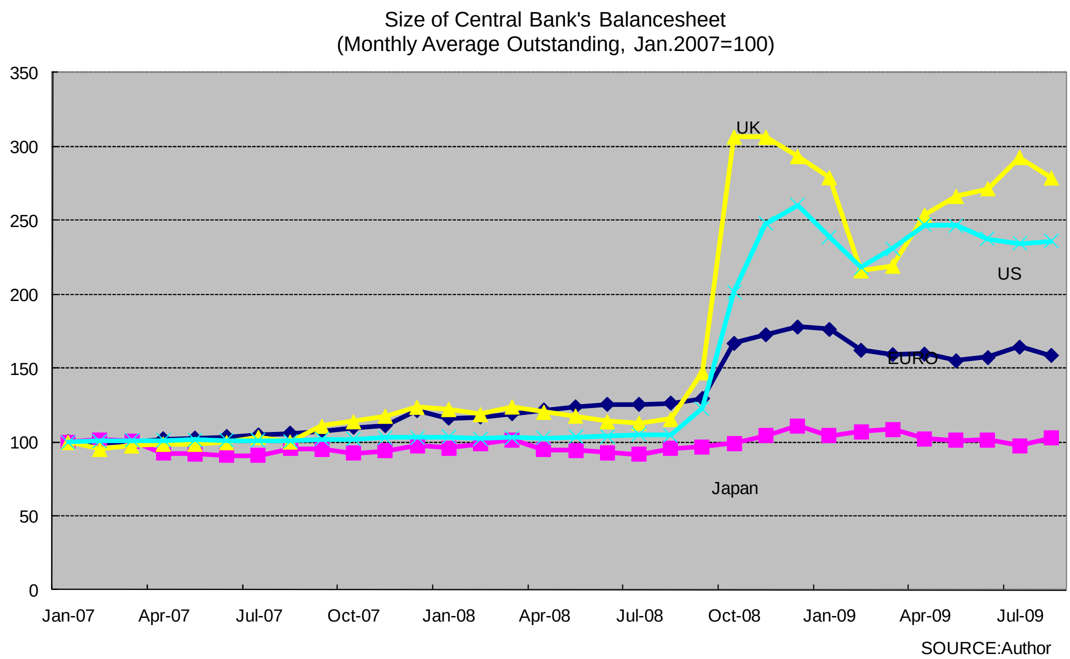


Figure 2

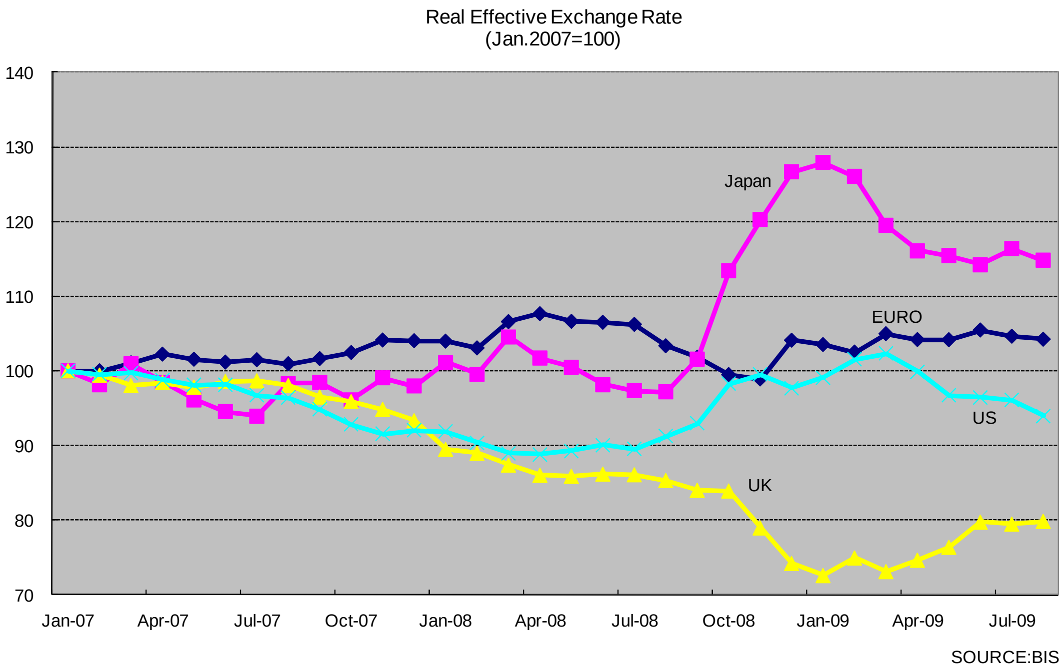
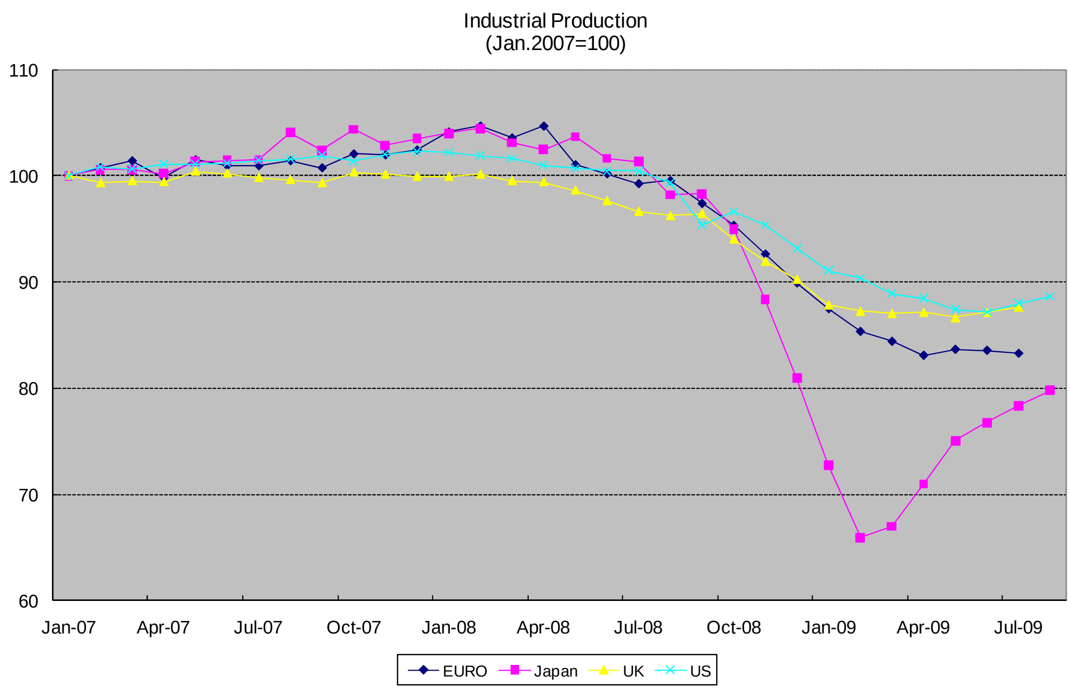


Figure 3



III-3: The BOJ against the Textbook Wisdom

According to standard macroeconomics, the government should expand monetary policy to counteract the reduced external demand caused by the sub-prime crisis abroad. Expansionary monetary policy will stimulate not only domestic demand by lowering interest rates or easing credit conditions, but also export demand by forestalling the appreciation of the home currency.

This is a simple application of the Mundell-Fleming analysis that illustrates that under flexible exchange rates monetary stimulus is relatively more effective than fiscal stimulus, and that monetary stimulus of a country exerts negative effects on the economy of its partners. These effects prevail in a standard macroeconomic model as long as inertia in prices is introduced. If Keynesian economics is back after the sub-prime, the Mundell Fleming framework must be return as well! The directions of those effects remain the same if we adopt a more general portfolio approach to exchange rate determination instead of the monetary approach to exchange rate determination.

Somehow, the BOJ did not follow this convention. Japan's monetary policy seems to have been conducted in the reverse direction against the conventional policy prescription (Bernanke, 2000; Ito and Mishkin, 2005, Hamada and Okada, 2009). In my second essay on this topic, I argued that the Bank of Japan did not proceed to increase money supply by hesitating to buy longer maturity public bonds or non government securities. I do not understand why, if the former Finance Minister understood the precipitous fall of industrial production, the monetary policy would be called "more satisfactory than expected."

In summary, the BOJ did not react at all in the face of sudden asset shocks of the higher yen and the resulting fall of foreign demand. Accordingly, the yen appreciated in real terms and the higher yen increased the burden on export industries and import competing industries. It is a great pity for the Japanese people to have a central bank that is reluctant to employ monetary instruments that would most likely lighten their pains.

III-4: Why Should Japanese Industries Suffer More than Other Countries?

The graphs in the last section indicate the asymmetry in output decline in major countries (regions). Though the epicenter of the sub-prime debacle was in the United States, and euro areas are also affected, the incidence in terms of industrial output was much more severe in Japan.[7]

Why does Japan suffer relatively more in terms of production? Since shocks to the financial structure from the asymmetric information must be more serious to the United States, the differences in the movement of the real exchange rate and industrial production are inferred to be generated by the different stance of the monetary policy. A new book by Kikuo Iwata[8] clearly demonstrates this linkage.

Some readers may attribute this difference to the industrial structure of Japan that relies largely on export. Then, the monetary stimulus through the real exchange rate change that I advocate will be even more effective. Also, I regard as unhealthy, the tendency the Japanese have to take responsibility for all the misfortunes in the world. For example, the global crisis emerged because the Japanese export too much. The sub-prime crash was caused by the carry trade invoked by the low interest rate. This self recrimination is wrong as I will explain in the last essay. Essentially, the sub-prime was not caused by the carry trade, but by the malfunction of information assessment, in other words, by the inability to detect lies in the financial sector,

III-5: Comparing with the Inter-war Period in Japan

The current view on monetary policy of the BOJ is in the tradition of an austere view that the BOJ adopted, wrongly I believe, at the inter-war period. In 1930, the BOJ attempted recklessly to return to the gold standard at the old parity that had prevailed before World War I. This policy led by BOJ Governor, Jun'nosuke Inoue purported to make people endure the high real exchange rate and obtain genuine competitive power. This policy of the yen appreciation of more than 10% in a year ended with a disastrous depression and the exhausting of the Japanese economy.

At the beginning of the 1990s, another Governor Yasushi Miyeno kept the discount rate high in spite of the peak of the stock market at the end of 1989 and its decline. The real exchange rate appreciated about 79 percent by the time that the yen exchange rate was

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[7] Unemployment rates, however, are recorded much higher in the United States than in Japan. The contrast to output figures can be explained by the difference in the Okun's coefficients that was studied by Kurosaka and Hamada a long time ago.

[8]

valued at 80 yen to a dollar. The long recession of the lost decade continued nearly ten more years.

Now, unfortunately Governor Masaaki Shirakawa of the BOJ seems to be following the same path. The BOJ allowed a substantial appreciation of the yen exchange rate by nearly 30%. Under the rigidity of prices and wages, this means a similar level of the real exchange rate appreciation that built a hard barrier for export industries and import competing industries. This is a kind of policy coordination with the United States and the United Kingdom because it allows those ailing economies some relief from depreciation of their currencies, but can Japan afford to be so charitable as to help its neighbors when a third of its national product is thrown into water?

In short, the BOJ is so eager to fulfill its obligation as a strict guardian of prudence in the financial market that it appears to have forgotten another important job, manager of quantitative monetary policy. When the BOJ, as a nightingale, forgot to sing, there is a no bird who can substitute for her role!

III-6: What Can Japan’s Monetary Policy Do?

Here are my recommendations that logically follow from the above.

(1) The monetary policy should ease the monetary conditions by engaging in unconventional market operations of not only short term government bonds but also longer term bonds and private securities. Since the global adjustment process is primarily to restore the sub-prime shocks in the United States, the yen may be allowed to appreciate a little, for example by 5%, but not by more than 25% as it actually happened. The moderate guideline would provide also an informal guideline for domestic monetary policy that is consistent with the exchange target.

(2) In case the above unconventional operations do not achieve the goal, the MOF may engage in currency interventions as was done by Vice Minister Mizoguchi during 2003 to 2004 – a period that was called the “great intervention” by John Taylor.

(3) As long as the monetary authorities, namely the BOJ and the MOF thoroughly understand the picture of asset markets and flow markets as I have explained them, it hardly matters to me whether we impose an inflation target on the BOJ. I would rather

allow the liberty to the BOJ, and to the MOF, to choose the monetary policy and the exchange rate policy that best fits the macro-situation in Japan. If they cannot understand it, or if they resist due to institutional vested interests, it may be necessary for Japan to impose quantitative price level targets, inflation targets, (from below as well as from above) on the Bank of Japan.

III-7: Concluding Remarks

We have seen a drastic contrast among nations (regions), that is, between the United States, the United Kingdom and the European Union on the one hand, and Japan on the other. In July, 2009, the International Monetary Fund (IMF) forecast the growth rate of Japan’s GDP as minus 6.0% as compared with that of the U.S. as minus 2.6%. On the other hand, the IMF forecast the price increase in Japan as minus1.0 % as compared with that in the United States as minus 0.9%. Moreover, the IMF expects that Japan will continue to be in deflation in 2010 as minus 0.6%. These forecasts indicate that their estimates seem to incorporate the contraction prone nature of the BOJ’s monetary policy.

The BOJ officials, including its Governor, make speeches on monetary policies in Japan as well as abroad. They emphasize the need to avoid crashes of bubbles by conservative monetary policy. Governor Shirakawa seems to be even proud of Japan’s austere monetary policy during Japan’s least happy period, the lost decade, as a restraining force against the crash. If we borrow Krugman’s metaphor, the BOJ officials apparently are saying that the economy is in a flood, but that we should be preparing for the next fire instead of dealing with the current deluge! When the economy is losing a major portion of its production, is it the right attitude for the central bankers? I cannot help but sympathize with the Japanese people who are losing their jobs, or their factories, because of the “forbearance” of the Bank of Japan.

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A graduate of the Faculty of Law and the Faculty of Economics of the University of Tokyo, Professor Hamada received a Ph.D in Economics from Yale University. His principal field of interest is international financial theory.

Following a long period of teaching at the University of Tokyo, Professor Hamada took up a position at Yale University in 1986. He was Director of the Economic and Social Research Institute of the Cabinet Office (Japan) from 2001 to 2003, and was the founding President of the Japan Law and Economics Association.

The Current State of the Japanese Economy:A Macro-Economist’s View
by Koichi Hamada