

# JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

## The Role of Monetary Policy in Japan

by Osamu Takemoto, the Bank of Japan

The following piece is a summary of an in-house KKC program, Japan Business Dialogue, held February 6, 2002 with guest speaker Osamu Takemoto, the Bank of Japan.

Japanese policymakers need to effectively combine many measures to restore sustainable economic growth. And the Bank of Japan needs to do its part by fulfilling its multiple roles: maintaining extremely low interest rates, stabilizing the financial market, improving the financial intermediary function, and providing abundant liquidity for the economy to meet demand fully. Monetary policy can become effective only when structural reform and other policy measures are properly implemented.

The Bank of Japan must also better explain the aims of its “quantitative easing” policy, since the public seems not to have a clear understanding of the purpose of the policy.

We should be well aware of the role of each player—that is, the government and the Bank of Japan—when we discuss further possible policy measures, including inflation targeting. At the same time, we should try to craft better policy measures including those that require coordination among these main players.

### Importance of Structural Reform

Fiscal stimulus and historically loose monetary policy have helped alleviate the effects of the burst of Japan’s “bubble economy,” but real growth has averaged just 1.1 percent annually for the past ten years. We need to effectively combine many measures to restore sustainable economic growth. Chief among them is structural reform, which is critical for reallocating Japan’s economic resources (capital, real assets and labor) to more efficient and productive sectors and players.

Because corporations are the main engines of economic growth,

structural reform in the corporate sector is especially important. We must raise entrepreneurs’ expectations of rates of return on investment. Deregulation and tax reform would improve business flexibility and profitability.

A quick resolution of non-performing loans may not bring about a brighter economy directly, but it would certainly help shift economic resources from less productive to more productive firms. The economy would grow faster if the financial system is strong enough to assume more credit risks.

Government policies and steps adopted by the corporate sector may take a long time to show results. Any structural reform measures may have many negative effects on the economy in the short run. As a result, a combination of different measures — including some policy measures to sustain aggregate demand — must be pursued in order to avoid hurting the economy too much during

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by Osamu Nakayama,  
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restructuring. Without much room left for fiscal policy, this leaves a narrow path for Japan, and it will be difficult to find a balanced approach.

Once structural reform is implemented – in conjunction with other policy measures to raise aggregate demand – however, powerful momentum will build to enable the economy to restore sustainable growth over the long run. In such circumstances, fiscal stimulus may become more effective, the corporate sector may invest more in the domestic market, and consumers may worry less about their future and spend more. Japanese people should push such reforms forward and bring about their positive effects as soon as possible.

## The Role of the Central Bank

The role of the central bank is essentially to provide liquidity in order to support the real economy and enable the financial system to function better, thereby helping achieve higher economic growth rates.

The recent measures of the Bank of Japan fall under four categories: maintaining extremely low interest rates, stabilizing the financial market, improving the financial intermediary function, and providing abundant liquidity for the economy to fully meet demand.

## The Aim and Meaning of “Quantitative Easing”

Many people assume that if a central bank provides sufficient

liquidity or monetary base (MB), it will affect the amount of the money supply (MS) more or less proportionately, which will in turn raise the price level and/or output in the long run. This is why some people expect the Bank of Japan to do more — to increase the current account target range, and/or maintain a high growth rate in the monetary base — in the face of mild but persistent deflation.

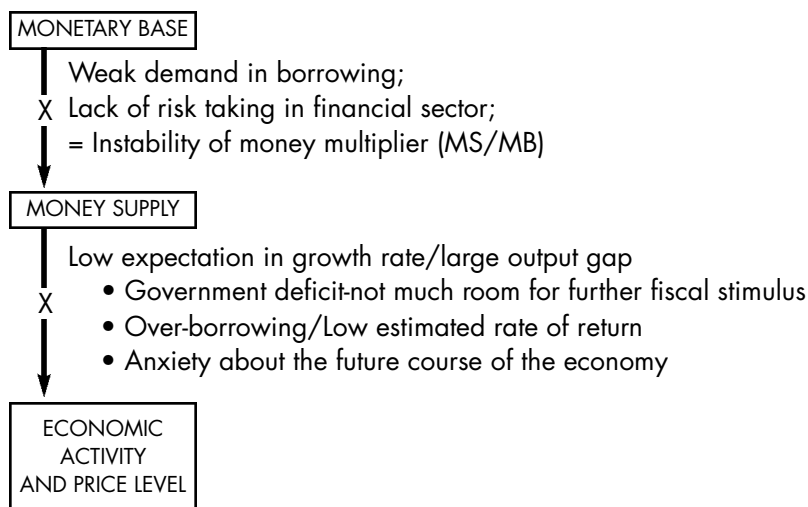
This widespread understanding reflects a misconception about the purpose of the quantitative easing policy. Quantitative easing policy does not seek to continuously increase the amount of the MB, simply believing that the MS will increase proportionately.

Rather, it seeks to foster an environment to help the economy to grow through other routes: through a combination of flattening the yield curve, stabilizing the financial market, and providing abundant liquidity to meet demand fully in the real economy, when needed.

## The Current Economic Situation in Japan

The relationship of the growth of MB, the growth of the MS, and the annual change of the core consumer price index do not hold one-to-one in the US. It is therefore quite astonishing that people assume that the relationship should hold

CHART 1  
CURRENT ECONOMIC SITUATION IN JAPAN



“The Bank of Japan must explain the aims of its “quantitative easing” policy, since the public seems not to have a clear understanding of the purpose of the policy.”

mathematically in the short run only in Japan.

Many people believe that the transmission mechanism from MB to MS operates in a stable manner, since it assumes sufficient demand in borrowing from the corporate sector and a willingness of the financial sector to take reasonable credit risks.

In the case of Japan, however, after the collapse of the “bubble

economy” and with structural reform under way, corporate sector borrowing is weak to begin with. In addition, the financial sector is not eager to take on new risks because it is suffering from the burden of non-performing loans and perceives the corporate sector as unprofitable (Chart 1).

Therefore, even though the Bank has increased MB substantially, it was not fully used, and the growth

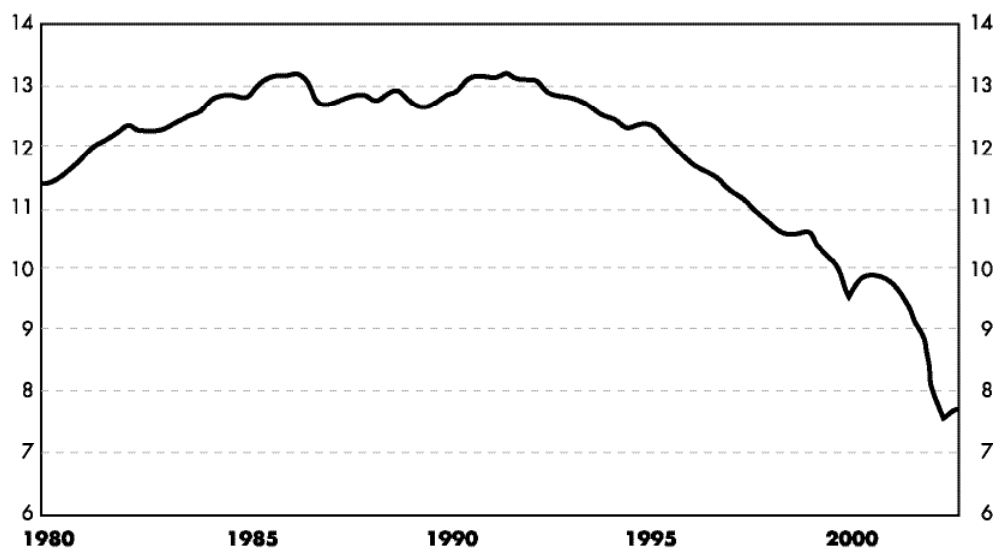
rate of the MS did not change significantly. To the contrary – the money multiplier (MS/MB) has been falling quite sharply. (Chart 2)

As for the relationship between the MS and price level/ economic activities, the quantity theory of money ( $MV=PY$ ) assumes that it is stable, and that demand in the real sector would strengthen once such the MS is provided in sufficient amount.

But in Japan, the current lack of demand is apparently a result of low expectations for growth (Chart 1). For example, there seems to be

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CHART 2  
MONEY MULTIPLIER (M2 + CDs/MONETARY BASE)



SOURCE: THE BANK OF JAPAN

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little scope for the government sector to exercise further fiscal stimulus since the gross level of the government deficit is already high. As for the corporate sector, companies are not eager to invest because of low estimated rates of return and over-borrowing. And in the household sector, consumption demand is not strong, partly because of anxiety about the future course of the economy.

Under these circumstances, the Bank of Japan considers it more important to bring about a favorable economic environment by providing abundant liquidity, to

“If the advocates of using unconventional measures believe such proposals would be effective for achieving sustainable economic growth, they should apply pressure to the government – not the central bank.”

restore the transmission mechanism from MB to MS. Merely pumping more and more MB into the economy would not be effective if it were not for such restoration (Chart 3).

### The Bank of Japan’s Responsibilities

The current easy monetary policy is not having much of a positive effect on macro economic

indicators by itself (Chart 4). But once the economy overcomes its structural and other problems, the accommodative policy will certainly exert a greater effect.

Needless to say, the Bank of Japan should not simply wait until structural reform and other policy measures succeed in revitalizing the economy. On the contrary, it must continue to pursue its chief

CHART 3

### MONETARY BASE, MONEY MULTIPLIER, AND MONEY SUPPLY (NUMERICAL EXAMPLE)

#### Case A. (normal economic situation)

	<b>Ex. 1</b>	→	<b>Ex. 2</b>
Monetary Base (MB)	\$100	(3% or \$3)	\$103
Money supply (MS)	\$1,200	(3% or \$36)	\$1,236
Money Multiplier (MS/MB)	12		12

#### Case B. (current economic situation)

	<b>Ex. 1</b>	→	<b>Ex. 3</b>	→	<b>Ex. 4</b>
Monetary Base (MB)	\$100	(50% or \$50)	\$150	(33% or \$50)	\$200
Money supply (MS)	\$1,200	(5% or \$60)	\$1,260	(4.8% or \$60)	\$1,320
Money Multiplier (MS/MB)	12		8.4		6.6

NOTE: AN INCREASE IN MB WOULD PUSH UP MS—A DOLLAR-FOR-DOLLAR OR SO, BUT THIS EFFECT IS LIMITED. IT IS MORE IMPORTANT TO RESTORE THE TRANSMISSION MECHANISM FROM MB TO MS, OR TO RAISE THE MONEY MULTIPLIER (MS/MB). THIS IS WHAT THE QUANTITATIVE EASING POLICY SEEKS TO ACHIEVE IN CONJUNCTION WITH OTHER POLICY MEASURES.

goals of maintaining extremely low interest rates, stabilizing the financial market, improving the functioning of the financial sector, and providing abundant liquidity to meet demand fully.

The Bank is often accused of being “slow” in raising the current account target range. This may stem from the misunderstanding of the aims of the quantitative easing policy, as just stated. The Bank needs to clearly explain and restate its aims.

Adopting a quantitative easing policy at any rate would be a risky course – it would be quite difficult for a central bank to move quickly without being sure of the likely results. That said, the Bank should explain to the public the concerns about the current policy and make further efforts to convince people by illustrating the possible risks to move forward.

#### Would “Unconventional” Measures be Useful?

Critics and politicians often urge the Bank of Japan to take “unconventional” measures to

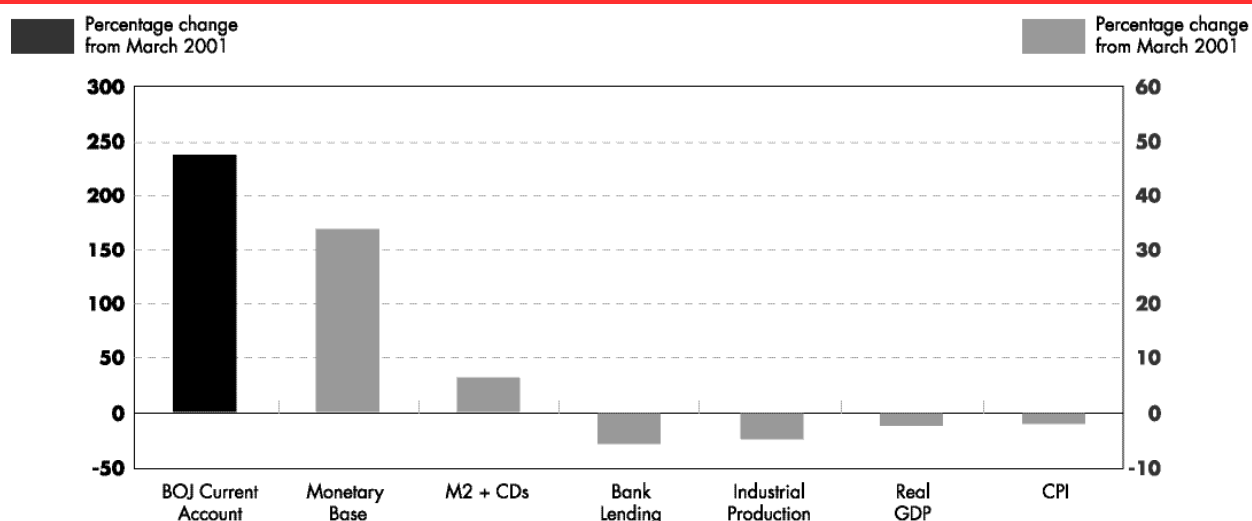
achieve more “effective” monetary easing such as: purchasing foreign bonds, or buying stocks (and/or Exchange Traded Funds, ETFs) and other assets.

If the purpose of using unconventional measures were to provide more liquidity, the Bank would be able to achieve it today, under the current policy. But if the idea is to pursue different aims—to weaken the Yen, or to affect asset prices directly, for example—it should be undertaken by the government. Intervention in microeconomic resource and capital allocation is

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CHART 4

### MONETARY AGGREGATES, ECONOMIC ACTIVITY AND PRICE DEVELOPMENT UNDER QUANTITATIVE EASING POLICY



NOTE: MOST RECENT AVAILABLE DATA AT THE TIME OF RESEARCH (NOV. 2002);  
CONSUMER PRICE INDEX EXCLUDING FRESH FOOD

SOURCE: THE BANK OF JAPAN

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“Many of the arguments for adopting inflation target, seem to be based on wishful thinking about the meaning and function of such targeting.”

fiscal policy. In a democracy, such action should be properly decided by legislators. If the advocates of using unconventional measures really believe such proposals would be effective and helpful for achieving sustainable economic growth, they should apply pressure to the government – not the central bank.

It is certainly difficult to call for new fiscal measures in the current circumstances, and we should thoroughly weigh their pros and cons. The government sector, however, could take further steps—e.g. a radical tax cut, purchase of a certain amount of non-performing loans, allowing the Banks' Shareholdings Purchase Corporation to take more market risk in purchasing bank-owned shares—in conjunction with other policy measures as deregulation, as part of a policy package.

If such a policy package were regarded by the public as substantial and effective, the additional fiscal deficit may not trigger a crash in the government bond market. If this were the case, coordinating government and the Bank actions, in terms of “financing” those fiscal

measures one way or another could become an option.

That said, history tells us that central banks in modern society should limit their role to what they do now. All-time low interest rates on 10-year Japan Government Bond (0.8 percent) already reflect a more than sufficient contribution from the central bank to facilitate the finance of the government.

### Is “Inflation Targeting” a Magic Wand?

The adoption of an inflation target has become the subject of hot debate amongst Japanese critics and some prominent politicians. Granted, the Bank of Japan should try to stabilize the price level, as it is required by law. Many of the arguments for adopting the target, however, seem to be based on misunderstandings and/or wishful thinking about the meaning and function of inflation targeting.

First, some seem to argue that merely setting an inflation target automatically increases the probability of boosting the consumer price index and that a central bank can control the price level at any rate once it sets an inflation target.

This is not at all logical. Any central bank should be able to control prices without setting an inflation target, as long as it has the will and tools.

Some critics strongly believe that deflation is simply a monetary phenomenon, and that the Bank of Japan can bring back price stability quickly by pumping enough liquidity into the economy. Deflation, however, is quite difficult to overcome because it may stem from different factors, such as economic innovation, deregulation and rationalization, the lack of aggregate demand, and the effect of globalization. Deflation or disinflation is no longer a Japan-only issue; it is becoming a worldwide phenomenon.

Nor is the argument that the announcement of an inflation-targeting policy itself would change people's expectations persuasive – people's expectations will not change by a mere announcement. It would just damage the credibility of the central bank, if there were no concrete measure to achieve.

Some arguments assume that the central bank alone is responsible for reaching an inflation target. But in reality, a range of efforts would also have to be made by government to reach the target by creating demand and promoting structural reform.

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The Bank of Japan and the government should work together, if indeed reaching the target is set as a national goal. Setting an inflation target at this stage, however, could be used by the government sector as an excuse to make it look like it is the Bank’s responsibility alone to bring back the price level.

Some politicians and critics seemingly want to use inflation targeting as a vehicle to put further pressure on the central bank to adopt unconventional economic measures. But these measures are not linked.

Finally, some seem to assume that reaching a certain level of inflation would directly translate to the achievement of a strong economy. Fighting deflation seems to be regarded by these critics as the main tool to restore growth, and that the Bank of Japan should do whatever it can to rescue the country. An economy with a reasonable or high growth rate may have mild inflation, but mild inflation is not a necessary condition.

High expectations about inflation targeting among ordinary Japanese people may stem from the double

meaning of *defure*. The Cabinet Office officially defines *defure* as deflation, but many people in Japan use *defure* as synonymous with a sluggish economy. Since “inflation” is an antonym of *defure* in one sense, it may sound to ordinary people that reaching a certain inflation level would directly lead to a stronger economy.

### **Importance of Healthy and Constructive Cooperation**

In some situations, inflation targeting would enhance the transparency and effectiveness of monetary policy. There are cases in other countries where this framework has been quite helpful, especially in reducing the inflation rate to a certain level. It is not at all clear, however, if this framework would work in a country already in a deflationary environment.

Nonetheless, if the misunderstandings and/or wishful thinking stated above about the meaning and function of inflation targeting are unfounded, such a policy could be considered in Japan, and the government sector and the central bank should engage thorough and constructive cooperation to achieve such goal. The recent debates on

inflation targeting in Japan may help people understand the fundamental function of the targeting policy.

Our real task is to find out better ways for the players—the Bank and the government—to cooperate, and inflation targeting could at most be one of the vehicles to help Japan achieve its ultimate goal – restoring sustainable economic growth. ■

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Views expressed in this text are those of the author and do not necessarily reflect those of the Bank of Japan.

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## Japan Business Dialogue

*KKC's monthly program featuring Japanese experts on the economy.*

### **Shinkansen: Japan's Tokaido Shinkansen is the Most Successful High-speed Passenger Rail System in the World**

Japan's high-speed passenger Shinkansen is the most successful high-speed rail system in the world, said Osamu Nakayama, general manager of Washington, DC office, Central Japan Railway Company (JR-Central) confidently.

Speaking at the March 13 Japan Business Dialogue, Nakayama explained that after the restructure of the Japanese National Railways, JR-Central, JR-East Japan, and JR-West Japan profitably operate passenger railroads, without any government subsidy — unlike the US's financially struggling Amtrak system.

Due in large part to Japan's topography and heavily-populated metropolitan areas, the Shinkansen is the predominant mode of transporting people for distances between 200 to 500 miles today. The Tokaido Shinkansen, the world's first high speed railroad system, amazed riders with a speed of 131 miles per hour when it was launched in 1964. And it amazed number-crunchers — in its first seven years, accumulated profits surpassed the total investment cost. New Shinkansen lines are under construction and still more are in the planning stage.

After the successful launch of the Shinkansen, several European countries were prompted to explore their own high-speed railroad system. France introduced the TGV system, and Germany, the UK, Italy, Spain, and Sweden established similar high-speed railroad systems. That said, in 2000, Japan's Shinkansen carried about 20 percent more traffic volume than all high-speed railroad systems combined in Europe.

What makes the Tokaido Shinkansen so competitive, Nakayama said, is its near-incredible safety record (6.3 billion passengers carried with no passenger fatalities or injuries) and on-time performance (the annual average delay per train in FY2001 was only 0.3 minutes, even with earthquakes, typhoons and heavy snowfall, and approximately 100,000 trains in operation).

The next generation of railroad lies in super-conducting JR-Maglev. The "magnetic levitation" Chuo Shinkansen is supposed to achieve high-speed travel (up to 500 km per hour), transport 10,000 passengers per hour in one direction, and make the trip between Tokyo and Osaka approximately in sixty minutes.

Developing a high-speed railroad system in the US — logically along the Northeast Corridor (connecting

Washington, DC, New York, and Boston) and the 400-mile corridor between San Francisco and Los Angeles — is intriguing.

Most Americans move by cars and airplanes, but a high-speed railroad with features such as safety, low impact on the environment, punctuality, huge capacity, and less energy consumption could contribute much. If a US commitment to developing a high-speed railroad system, JR stands ready to help, Nakayama concluded. ■

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