

# JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

## Are We Repeating the Same Mistakes? A Look at BOJ Steps to Change Monetary Policy

BY SHUNPEI TAKEMORI, KEIO UNIVERSITY

When the Bank of Japan ended the so-called quantitative easing policy in March, many attributed it as a sign that the Japanese economy is returning to normal. Generally speaking, there is no mistake in this view. The shift in direction means that after a period during which both fiscal and monetary tools were fully mobilized to curb the downward trend in consumer prices that began in 1995, monetary policy is recovering its usual position and can henceforth include inflation constraint among its goals. Since a favorable business climate has lasted for some time, there is nothing amiss in the thinking that monetary policy should once again place inflation among its concerns. A shift to a stance of inflation prevention has already occurred in the United States, where the Federal Reserve Board placed rising prices among its concerns in the first half of 2004.

Despite the existence of conditions in Japan justifying a change of direction in monetary policy, the decision to end quantitative easing sparked a huge domestic debate. Even Prime Minister Junichiro Koizumi, who has staked his reputation on his reform program and parted ways with fiscal stimulus featuring lavish spending on public works, remarked at one point that it might be too soon for the BOJ to act—a comment that caused people to give the issue yet more attention.

To properly appreciate the unfolding of this drama in Japan, one needs to be aware that the BOJ in the 1990s was unsuccessful in keeping the economy on an even keel. As a result, neither the public nor the political world places much confidence in the bank's ability to reach wise decisions. The monetary authorities in Japan were thus in an entirely different position than was the Fed in the United States under former Chairman Alan Greenspan, who was said to never make a mistake. This reputation was based on the solid performance of the US economy, which in the 1990s enjoyed its longest period of stability since World War II.

### Atoning for past mistakes

The BOJ's poor past performance caused a number of politicians in the ruling coalition to request that a specific "inflation target" be set if quantitative easing was to be brought to an end. These politicians had seen the BOJ commit another policy error in 2000, one that did decisive damage to its already tarnished reputation, when it prematurely terminated its "zero-interest-rate policy"—holding the uncollateralized overnight call rate basically at zero percent—even though deflation had not at that point been entirely rooted out. Quantitative easing was then brought in by way of atonement for this mistake. That is, after overriding opposition from the Ministry of Finance and jacking up the overnight call rate, only to see the economy take a turn for the worse, the BOJ was reluctant to simply return the rate to zero, since that would have been tantamount to admitting its erroneous judgment. It therefore decided to introduce a new policy instead.

This new policy of quantitative easing, which began in 2001, entailed the setting of a target for the funds commercial banks keep on deposit in

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current accounts at the central bank. Initially the target was ¥5 trillion, but the figure was subsequently moved much higher, reaching ¥30 trillion in 2003. The BOJ had gained a reputation for a passive stance toward deflation, and this made it a surprise when it jacked its quantitative target to such a high level. In the background the appointment of a new governor for the bank in 2003, but of even greater significance was a massive intervention in exchange rates organized by MOF in the same year—the largest such act of intervention in the world's history, with a total value of ¥33 trillion. It is no coincidence that this is close to the ¥30 trillion quantitative target the BOJ set. The BOJ moved its target higher in support of MOF's intervention.

There are two basic ways in which intervention in currency markets is conducted. If the objective is to hold the value of the yen down against the dollar, MOF will sell yen and buy dollars. In response, the BOJ

can "sterilize" this action by making moves to ensure that the money supply does not increase, or else it can allow the money supply to grow in a "nonsterilized" intervention. What happened in 2003 is that MOF raised yen from the market for its intervention by issuing short-term securities, while the BOJ supplied yen to the market through its buying operations. In effect the central bank was issuing yen to pay for the intervention, making it a clear case of a nonsterilized operation. Most economists are of the view that when the objective is to prevent a currency's appreciation, nonsterilized intervention is the most effective.

The appointment of a new governor was one of the factors prompting the shift to cooperation between the BOJ and MOF, which had been in bitter opposition when the central bank unilaterally tried to back away from zero interest rates in 2000. A far more important factor, however, was US

economic policy. In 2001, following the bursting of the information-technology bubble in March 2000, the Fed adopted an aggressive stance of monetary relaxation, and the US administration supported it with big tax cuts. These moves were beneficial for Japan in the sense that they stimulated exports, but they also had the potential to worsen Japan's deflation if they weakened the dollar. When this deflation had set in back in 1995, after all, one of the causes was the yen's climb to, at one point, a level stronger than ¥80 to the dollar. With this in mind in 2003, the BOJ and MOF shared the view that the Japanese economy would suffer devastating damage if the yen were allowed to soar again to such heights.

### Opting for an inflation range

Mistakes made in both fiscal and monetary policies were behind Japan's "lost decade," when economic growth limped along at a one percent pace, even falling below zero in 1997 and 1998. At the crucial juncture when the Japanese economy first began to founder, neither the BOJ nor MOF went far enough in deploying stimulus measures. In the United States, by contrast, the Fed and the administration responded to the collapse of the IT bubble by joining hands in a truly aggressive initiative. At the time, their

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action came as a goad for Japan's fiscal and monetary managers.

When the threat of the yen's appreciation receded and prosperous times settled in, however, a divergence of opinions between MOF and the BOJ emerged once again. The single most important concern from MOF's point of view is the swelling of public debt, which has mushroomed to 170 percent of gross domestic product. This might be a supportable burden if interest rates could be held to about 1.5 percent, but if they rose to five percent as in the United States, debt-servicing costs alone would reach 8.5 percent of GDP (170 percent times 0.05).

The BOJ, however, does not want to have to manage monetary policy so as to hold interest payments on the public debt to a low level, as that would mean regressing to the thinking of the years before maintaining price stability emerged as the standard policy goal of the central bank. In the case of the

United States, that was the age prior to the Treasury–Federal Reserve "Accord of 1951," when the Fed was obligated to hold the long-term interest rate on government bonds within 2.5 percent.

In this context, many Japanese macroeconomic experts recommended that the BOJ announce a specific inflation target and that it clarify the goal of its monetary policy as price stability, not government bond management, while at the same time offering the reassurance that it would not prematurely tighten the monetary reins in deflationary conditions, as it did in 2000. To some extent, this is precisely the course the central bank has taken. But instead of setting a specific inflation target, it has specified an inflation range between zero percent and two percent. And when measurement error is factored in, the zero percent at the bottom of this range opens the door to deflation.

### **Bubble deflation: A mistaken policy target**

The reason for the bank's avoidance of a more explicit commitment to prices is that it wants to leave the door open to monetary measures targeted broadly at land and other asset prices, not just at prices of goods and services. This brings up the problem of how to summarize Japan's lost decade, which further involves a difference in philosophy between the BOJ and the Fed in what monetary policy to apply to speculative bubbles.

Former Fed Chairman Greenspan had a clear policy line for dealing with bubbles. He held that it was impossible to ascertain beforehand whether an upward trend in asset prices reflected real conditions or was due to a bubble. If it turned out to be a bubble, it would deal damage to the real economy in such forms as an increase in nonperforming loans when the bubble collapsed. A central bank therefore needed not to deflate the bubble by making money tighter but to await the bubble's natural collapse, at which point, if the collapse was causing harm to the real economy, it should step in with aggressive monetary relaxation to prevent the economy from stalling. Because this was the course the Fed followed in the United States in the wake of the IT bubble's collapse in

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2000, the ensuing economic downturn was the second shortest since World War II.

When the BOJ moved to tighten credit at the start of the 1990s, by contrast, it was plainly trying to deflate a bubble. The aftereffects of the bubble's collapse became more severe as a result. The bank's governor at the time made an unambiguous admission of responsibility for having invited the bubble's formation by leaving interest rates low for an overly long period in the second half of the 1980s, but he accepted no responsibility whatsoever for prolonging the ensuing slump by failing, out of fear of the bubble's return, to loosen credit aggressively.

Since the BOJ has not subsequently announced a change in position on this matter, it is reasonable to presume that the bank's stance on official

monetary policy includes the adoption of measures to stop speculative bubbles from forming. The problem with this stance is that even at times when asset prices are rising as a reflection of not a bubble but an improvement of the economy's prospects, the bank may futilely tighten its monetary policy in a bid to halt the price rise. There is also the danger that after a bubble has formed, the bank may seek to puncture it by recklessly pulling back on the credit reins, possibly resulting in an aggravation of the ensuing economic downturn and the buildup of bad debts.

Recently the praise for the Koizumi administration's contributions to the economy's recovery has been drowned out by criticism of widening income differentials, which are said to have been invited by the Koizumi reforms. This brings to mind the nonsensical, though

popular, notion of the bubble years about how rising land prices had made it difficult to buy a home and therefore impoverished the Japanese. According to this argument the wealth of the nation (the value of its land) increases, and people become poor as a result. Now just the reverse has occurred, with land prices falling over a period of almost 15 years. But would anyone claim this has made Japan richer?

These days land prices in the metropolitan centers of Tokyo and Nagoya have begun to visibly climb. But even though we ought to be greatly relieved that land prices have at long last returned to an ascent, some newspapers and other media sources seemingly suggest that this gratifying development portends the rekindling of a bubble for which the government is to blame. This is truly *déjà vu*. Hopefully this time the BOJ will not adopt a mistaken monetary policy aimed at bubble deflation. It is apparent that the time has come for a recapitulation of the lost decade. Japanese must get to the bottom of who caused the decade to be lost and what they did wrong.

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# The Koizumi Legacy

BY STEVEN VOGEL, U. C. BERKELEY

Prime Minister Junichiro Koizumi, elected in 2001, who has served longer than any Japanese leader since Eisaku Sato (1964-72), is expected to step down in September. When historians look back on this era, what will they identify as Koizumi's legacy? Although Koizumi came to power under the banner of economic reform, his greatest impact has come in the realm of politics—both domestic and foreign—not economics.

## Domestic Politics

Koizumi's single greatest achievement was masterminding the LDP's (Liberal Democratic Party) phenomenal victory in the September 2005 election. When some members of his own party voted against his postal reform bill in the Lower House, he threatened to dissolve the body if LDP members prevented

passage in the Upper House. When the bill did fail, Koizumi astounded his opponents by carrying through with his threat. He not only called the election, but he ousted those LDP Lower House members who had voted against the bill from the party and sponsored "assassin" candidates to run against them.

The LDP's huge victory is doubly puzzling. If the Japanese people really wanted political change, then why did they vote for the ruling LDP rather than the opposition Democratic Party of Japan (DPJ)? And if the Japanese people really wanted economic reform, then why did they vote for the LDP, which focused exclusively on postal reform, rather than the DPJ, which proposed a broader agenda of economic reform?

Once we recognize that the election was really more about reforming the LDP than about reforming the economy, however, then the puzzle disappears. That is, the Japanese people did not vote for an alternation in the party in power, from LDP to DPJ, but rather for a transformation of the party in power, from old LDP to new LDP. Koizumi shrewdly capitalized on public frustration with old-style LDP politics, and persuaded voters that they could do more to change the LDP by voting for it than against it. Then Koizumi added some irresistible drama to the story by throwing members of the LDP's old guard out of the party, and he took his case directly to the people via television. The party emerged from the election with a much more even balance of support from urban and rural districts—as opposed to the usual pattern of much stronger support in rural areas—plus a large new cohort of "Koizumi kids:" first-term Diet members who owed their victory to Koizumi.

The 2005 election was the culmination of Koizumi's campaign to save the LDP by attacking it. He undercut the party machine directly by reducing public works spending and challenged it indirectly by promoting reform of the postal finance system

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and the special public corporations that channel much of this spending.

In essence, Koizumi transformed the LDP by undermining the party's clientelistic networks and by reducing its reliance on rural voters. He also contributed to an ongoing shift in LDP campaign strategy from a focus on the mobilization of core support groups to greater attention to media, image, party leadership, and policy issues. In the process, ironically, Koizumi may have struck the death-blow to the structure that sustained the LDP's long-term rule, and opened the door to more volatility in party support and a greater possibility that the LDP will lose power within the foreseeable future.

### Foreign Policy

When he came to power, Koizumi was expected to direct more energy and stronger personal conviction toward economic reform than foreign policy—yet he actually acted more decisively on the foreign policy front. The United States had asked Japan to contribute to the first Persian Gulf War in the early 1990s, but the Japanese government became mired in endless domestic debate. In the end, Japan made a massive financial contribution but virtually no military contribution, leaving Japan's allies dissatisfied with Tokyo's "checkbook

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diplomacy" and many Japanese understandably frustrated.

By contrast, Koizumi orchestrated a much more rapid and decisive response with the more recent conflicts in Afghanistan and Iraq. To accomplish this, the Japanese government had to pass legislation that substantially stretched the limits of Article 9 of the constitution, thereby redefining the role of Japan's military forces. In the process, Japan substantially upgraded its security alliance with the United States. Koizumi also pushed forward the process of considering revisions to the postwar constitution, including Article 9. Meanwhile, Koizumi considerably strained relations with China by repeatedly visiting the Yasukuni Shrine, where Class A war criminals

are buried and a museum espouses a distinctively Japanese interpretation of the country's wartime past.

### Economic Reform

While economic reform was the dominant theme throughout much of Koizumi's tenure, his achievements in this arena were arguably less dramatic than the changes in domestic politics and foreign policy. For one thing, many of the reforms that are attributed to Koizumi were actually under way before he took office. The Japanese government had been working on regulatory reform, decentralization, and special public corporation reform for years. Koizumi simply built on this foundation. Moreover, the actual substance of some of the Koizumi reforms has been less impressive than the rhetoric and the sheer scale of the

effort. Even in the case of Koizumi's favored project, postal reform, he made considerable concessions to reform opponents and left the detailed implementation to his successors. Likewise, in the case of the special public corporations, Koizumi's rivals within the party successfully fought back against budget cuts in key areas, such as highway construction.

Precisely because Koizumi's reforms were motivated more by politics than economics, his priorities were somewhat misplaced in terms of their potential economic impact. Given Koizumi's enormous popularity upon assuming office, he had considerable political leeway to devote to his reforms. He spent much of this political capital on his favored structural reform projects, devoting less attention to the most pressing issues for the economy: combating deflation and resolving the banking crisis. To his credit, the administration finally addressed these problems, and this certainly played a critical role in driving the current economic recovery. But he certainly could have acted sooner and more decisively.

### Japan's New Economic Model

While Koizumi himself did not initiate the process, he played an important role in carrying out

incremental reforms in some areas that have garnered less attention, yet are critical elements of the ongoing transformation of the Japanese economic system. Since the economy faltered in the early 1990s, the Japanese government has pushed through a wide array of reforms in areas such as labor, finance, accounting, corporate governance, and antitrust.

These reforms have given corporations more options in coping with changing economic conditions. Japanese companies have taken advantage of these legal changes by starting private employment agencies, hiring agency temps, issuing stock options, buying back shares, and forming pure holding companies—just to mention just a few examples.

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In my recent book, I contend that these policy reforms and corporate adjustments have combined to produce a substantially revised Japanese economic model. In sum, the remodeled Japan differs from the earlier version in at least three important ways.

- It is more selective: In the face of hard times, companies have re-evaluated their long-term relationships with workers, banks, and other firms, and they have loosened some and tightened others.
- It is more differentiated: Companies have become more variable in their practices. There never was a uniform Japanese model that applied equally to all sectors and all companies, but the model has fragmented further.

- And it is more open: Japanese corporations have more foreign owners, managers and business partners than ever before, and these foreign actors bring with them different practices and norms.

While Koizumi's structural reforms themselves have not transformed Japan into a liberal market economy, the increasing foreign presence in Japanese business implies that foreign firms now have better access to the

Japanese market and more influence within Japanese policy debates, and that the very incremental process of economic change in Japan is likely to accelerate, if only slightly.

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