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The Role of Monetary Policy in Japan: A Break in the 1990s?[1]

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This article documents time series evidence suggesting the case for a possible structural break in the role of Japan's monetary policy during the 1990s. It uses a simple vector autoregressive framework and offers some suggestive results: While a persistent effect of monetary policy on real output is detected over the full sample of 1975–1998 and the subsample that ends in 1993, such effect disappears with the recent subsample of the 1990s. The stability analysis also provides more specified evidence that there is a break in the reduced form dynamic system in 1995. Some interpretations are offered to intuitively support these findings. *J. Japan. Int. Econ.*, December 2000, **14**(4), pp. 366–384. Research Institute for Economics and Business Administration, Kobe University, Rokko, Nada, Kobe 657-8501, Japan. © 2000 Academic Press

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1. INTRODUCTION

The role of monetary policy in Japan to promote its economic recovery has attracted considerable attention in recent policy debate. Among others,

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Krugman (1999) advocates that monetary policy can be potent if the central bank committed itself to an expansionary stance strong and long enough to eventually raise the expected inflation. Okina (1999) discusses the practical issues surrounding a further, strong easing stance such as the difficulty of controlling inflation to a desired target level and argues that the potential costs presumably outweigh the possible benefits. The pros and cons by several economists can also be found in the comments and discussions to Krugman's article (1999, pp. 188–203).

To evaluate these alternative views, it would be helpful to examine the relationships in the actual data and have a quantitative assessment on the potency of monetary policy in Japan. Here the focus is the development of the Japanese economy in the 1990s and more specifically the possibility of a structural shift in the role of monetary policy in recent years. The Japanese economy has been stagnating ever since the burst of Japan's so-called "bubble economy," which refers to the strong economic boom of the late 1980s associated with unusually high asset prices. On the monetary policy front, the official discount rate was lowered from 6% to 0.5% during the early 1990s to prompt recovery. The call market rate, the central policy instrument of the Bank of Japan, was also reduced to an unprecedented decimal level. But the expected strong recovery has not been felt yet. One possible explanation is that these moves are largely not exogenous, active policy actions, but passive, endogenous responses to the stagnated economy. This line of argument is explored in my earlier paper (Miyao, 1999). Another possibility would be a significant shift in the role of monetary policy sometime in the 1990s, so that even policy actions that are identified as active may not be as effective as before. Was there any break in the role of monetary policy recently in Japan? What do the data tell us about a possible structural shift in the potency of monetary policy as well as the overall Japanese economy? If any break is probable, then when is it most likely to have occurred?

This paper attempts to answer these questions using a simple econometric framework based on the vector autoregressive (VAR) methodology. Monthly observations spanning from January 1975 to April 1998 are used in the empirical analysis. The main findings of the paper can be summarized as follows. The impulse response results suggest that while a persistent effect of monetary policy on real output is detected over the full sample period and the subsample that ends in 1993, such effect disappears with the recent subsample of the 1990s. The stability analysis of Christiano (1986) and Cecchetti and Karras (1994) also provides more specified evidence that there is a significant break in the reduced form dynamic system most likely in 1995. To intuitively support these findings, we offer some possible interpretations based on the following three economic events in 1995: (i) the yen appreciation to over 80 yen per dollar, (ii) the Bank of Japan's actions to lower the official discount rate or the call rate to a record low below 1%, and (iii) the series of bank failures that disclosed the serious bad loan problem in Japan's financial sector.

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