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On the Role of Monetary Policy in a Deflationary Economy: The Case of Japan[1]

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In this paper we review the role of monetary policy for a country facing deflationary pressure based on the recent experience of the Japanese economy. We discuss economic background of inflation policy in Japan and analyze the impacts of the policy. We made simple calculations regarding how much the debt of selected companies and government can be reduced by mild inflation. Noting that the Fisher effect does not work perfectly under liquidity traps, the effect of inflation on debt issue appears quite large. To maintain controllable stable inflation, inflation targeting is a good candidate for the policy rule. *J. Japan. Int. Econ.*, December 2000, **14**(4), pp. 238–260. Graduate School of Economics, University of Tokyo, 7-3-1 Hongo, Bukyo-ku, Tokyo 113-0033, Japan. © 2000 Academic Press

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1. INTRODUCTION

The macroeconomic performance of the Japanese economy in the 1990s provides an interesting case on the role of monetary policy in a deflationary economy. Despite the series of aggressive fiscal and monetary stimulating policies, the Japanese economy could not recover from deep recession. Rather, as a result of these policies, the short-term interest rate, the policy target of the monetary policy of the Bank of Japan, fell to almost zero, and the government debt accumulated to a historically high level. There seems to be no room for further stimulating the stagnant economy.

Paul Krugman's model of liquidity traps (Krugman, 1998) provoked controversy on the role of monetary policy in a deflationary economy. According to Krugman, the present state of the Japanese economy is in a liquidity trap. In contrast to the old-fashioned Keynesian view that monetary policy is ineffective under liquidity traps,

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Krugman pointed out that an aggressive monetary policy under which the central bank commits to sustained inflation for a certain length of time is quite effective for freeing the economy from the liquidity trap. He suggested that 4% inflation for 15 years is necessary for the Japanese economy to recover from the liquidity trap.[2]

In Japan there have been increasing requests for economic policies generating some modest inflation. There are some divergent views on this inflation policy: some have Krugman's policy formula in mind, but some have a completely different one in mind.

The idea of inflation policy originally emerged in the early 1980s, when the Japanese government faced a serious government debt issue. Inflation, at that time, was considered an effective way to decrease the real value of government debt in a short period. Although the idea could not obtain much consent at that time, the economic environment in the late 1990s was far more favorable to the argument for inflation policy than that in the early 1980s. The government debt was much higher in the late 1990s than in the early 1980s. Furthermore, a large number of private firms, which now faced serious balance sheet losses due to a crash in stock and land prices, saw that an inflationary economic environment was far better for their balance sheet correction than a deflationary economic environment.

It has also been pointed out by many people that, even if intentional inflationary policy is not taken now, skyrocketing government debt will trigger serious inflation in some point in the future. The lack of sustainability of government debt has alarmed an increasing number of people. The fact that the market interest rates on long-term government bonds are still very low indicates that the market still believes in the sustainability of government debt. So, it may be too early to raise the question of sustainability on government debt. However, based on experiences of various countries in the past, it is very rare for a country whose government debt–GDP ratio exceeded a certain levels to decrease that ratio without causing some inflation.

In fact, some casual observations on the political aspect of the monetary policy in Japan in previous years suggest that there will be increasing pressures on the Bank of Japan from the government as well as the corporate sector to introduce stronger monetary measures which will generate inflation: it may even include the purchase of newly issued government bonds by the Bank of Japan, which is banned by the present Finance Law. In the process of accumulating government debt, interest rates on long-term government bonds may increase, and in that case, the political pressure on the Bank of Japan to increase its purchase of long-term government bonds will become very strong. This is a typical scenario of increasing government debt leading to inflation. Some people advocating inflation policy claim that present intentional modest inflationary policy is far better or less evil than forced and uncontrolled inflation in the future.

Discussion on inflation policy provoked various interesting questions on the role of monetary policies in a deflationary economy. Such issues were raised

[2] Krugman (1998).