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Price deflation and consumption: central bank policy and Japan's economic and financial stagnation

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Abstract

In this paper we review the major causes of Japan's economic and financial stagnation during the past decade, considering in particular how past policies of the Bank of Japan have generated the current deflationary environment. This paper does not attribute Japan's economic and financial distress entirely to Bank of Japan policy nor does it fail to recognize the shift in policy starting March 2001 when the Bank shifted toward a policy of "quantitative easing" that generated a significant increase in the growth of high powered money by late 2002. The paper argues the Bank's deflationary policies starting in the mid-1990s up to late 2002 exacerbated the distress and it remains to be seen whether the new policy will reverse deflationary expectations. We consider the economic effects of the deflation, and in particular we argue for a link between expected deflation when nominal interest rates approach their lower bound and a decline in consumption. We find some initial evidence for this hypothesis using both a simple two-period model with a simulation and estimates of consumption functions for both the United States and Japan. Re-inflation is thus a necessary, though not a sufficient condition for Japanese economic recovery.

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1. Introduction

Japan's economic and financial malaise has been extensively documented.¹ Despite much research effort and the lack of success of the numerous fiscal, monetary, and regulatory policy responses, including institutional redesign efforts and attitudinal changes by Japanese policy makers, debate persists over the causes of Japan's downturn, the causes of the continued stagnation, and the set of policies that will return Japan to sustained economic growth. Some view Japan's problems from a broader perspective. Krugman (2000), for example, argues that Japan is a leading indicator of "depression economics", that liquidity traps will increasingly confront policy makers, and that a new government paradigm is required to deal with these problems in the future.

The apparent lack of consensus reflects the more general difficulty of assigning responsibility for the cause of any major economic event. First, the impact of any exogenous shock to the system, such as the Bank of Japan's decision in May 1989 to initiate a tight money policy, is dependent on the existing structural characteristics of the real and financial sectors. Even if one can identify an initiating exogenous shock, it is not easy to assign causal importance to the shock since other shocks might have generated a similar response. Second, the causes of Japan's economic and financial malaise multiply in number and complexity as the problems persist. The longer lasting the problem, the more the problem becomes embedded throughout various sectors of the economy, the more difficult to identify any small set of causes, and the more difficult it becomes to reverse the process.

This paper, however, takes the view that despite the difficulty of assigning the status of "cause" to any one or small group of factors, the broad causative outline of Japan's stagnation can be identified and that a *necessary*, but not sufficient, condition for recovery can be identified. The paper specifically focuses on Bank of Japan policy, the gradual but definite decline in the price level, and the effect deflation has had on consumption spending.

The remainder of the paper is composed of five sections. In Section II, we present a causal outline of Japan's economic and financial stagnation drawn from the exiting literature. Section III summarizes the evidence that Bank of Japan policy has been insufficiently stimulative and as a result, has permitted the price level to fall after 1995. Section IV focuses on the link between deflation and aggregate demand from three perspectives: (1) a simple two-period theoretical model that illustrates why even if deflation is anticipated, consumption spending will likely decline; (2), a simulation of the theoretical model to illustrate how consumption spending responds to deflation; and (3), estimates of two consumption functions that suggest an empirically meaningful relationship between deflation and consumption spending in Japan. The theoretical and empirical model are not complex, but suggest that there is a link between deflation, even when anticipated, and consumption. To the extent central bank policy is responsible for the deflation process, the economy cannot recover until a reflation

¹ The following is a selected list: Cargill et al. (1997, 2000); Cargill and Yoshino (2003); Freedman (1999); Hoshi and Patrick (2000); Lincoln (2001); and Posen (1998).

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