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Japan's economy and monetary policy: a pragmatic evaluation☆

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Abstract

Based on 30 years of experience, I try to explain why the Bank of Japan was more pessimistic in October 2001 as compared to April 2001. This change should be attributed to a slow down in the overseas economy and the price pressure it brings on Japanese economy. In response the Bank changed the main operating target from overnight call rates to the outstanding balance of current accounts. It committed to this policy till prices stopped deflating. This, it was hoped, would discourage banks from holding excess liquidity, but such a change has not occurred. The Bank committed to increase its purchase of long-term government bonds. With the decline in the role of banks in financial intermediation, financial markets become more important, but the stock prices are not responding to monetary relaxation.

Keywords: Financial intermediation; Monetary policy targets; Japanese recession

The following remarks are based on my 30 years' experience with the central bank of Japan. They attempt to evaluate the state of Japan's economy and the conduct of monetary policy from a practical rather than a theoretical viewpoint and are divided into four parts: Japan's recent economy; the conduct of monetary policy in the recent period; the effect of monetary easing; and some concluding remarks.

1. Japan's recent economy

In its October 2001 monthly economic report, the Bank of Japan expressed the following view on economic and financial developments: "Adjustments in economic activity are

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becoming more severe as the substantial decline in production negatively impacts employment and income conditions. In addition, the terrorist attacks in the US have further heightened uncertainty."

A detailed examination of final demand will help readers understand why such a gloomy picture was painted at that time: net exports were still declining not only due to a slowdown in overseas economies but also sluggish demand for information-technology (IT)-related goods; business fixed investment was also decreasing noticeably, particularly in manufacturing; future demand for the IT-related sector had been revised downward; housing investment remained sluggish; public investment was declining (e.g. the value of public works contracts had been at a low level since the start of fiscal 2001); and private consumption remained almost flat on the whole, with somewhat weaker indicators being increasingly observed.

Reflecting these developments with respect to both domestic and external demand, industrial production continued to decline considerably. Although the increase in inventory was beginning to peak due to the decrease in production, inventory remained excessive in many areas, especially in those related to electronic parts and materials.

Moreover, as speculation had become more widespread that a further deceleration in overseas economies was inevitable due to the terrorist attacks in the US, the business outlook of Japanese exporters became more cautious.

As far as the export outlook was concerned, the prevailing view in October 2001 was that the environment surrounding external demand would turn favorable by around spring 2002. However, there was the risk that the terrorist attacks might prolong the downturn in US consumption, which would induce another round of adjustment in the Japanese economy.

Meanwhile, with respect to the outlook for domestic demand it was anticipated that business fixed investment would follow a downward trend in view of not only the continuing decline in corporate profits but also the successive downward revision of investment plans in IT-related sectors. It was expected that private consumption would weaken gradually reflecting deteriorating employment and income conditions. Thus, a vicious circle where low corporate profits led to lower employment and income, in turn leading to lower corporate profits, was observed.

In April 2001, the Bank of Japan had published a rather gloomy semi-annual economic outlook and risk assessment, but as described above, the Bank's view on the Japanese economy in October was even gloomier. What were the factors behind this change in perception from April to October?

Let me begin with the baseline scenario of the Bank's view in April. First of all, in the first half of fiscal 2001, the economy was deemed to likely remain sluggish as a result of a decline in exports and production against the background of a global slowdown. Second, with respect to the latter half of fiscal 2001, it was thought that the recovery of the US economy would lessen downward pressure on Japan's economy. Third, it would take time for the economy to show a clear sign of recovery because of persistent pressures arising from various structural problems. Fourth, it seemed likely that the output gap would continue widening and prices would remain weak throughout fiscal 2001.

At the same time, the Bank identified four major risks: (i) developments in overseas economies, especially in the US, and in IT-related industries; (ii) developments in the