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Contained crisis and socialized risk Unconventional monetary policy by the Bank of Japan in the 1890s



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ABSTRACT

In the 1880s, Japan experienced its first stock investment boom, which was highly leveraged by the banking sector. In 1890, its first financial crisis occurred and triggered a de-leveraging process. With a high lower bound of the conventional interest rate intervention under the fixed exchange rate regime, the Bank of Japan decided to implement a massive securities purchases first time among major industrial economies and continued this unconventional policy until the early 1900s. We examine how the unconventional intervention for a decade affected the stock prices and the trade volumes, and show that the upward distortion in market pricing was considerable and that the equity-risk premium accordingly dropped, which meant socialization of the risk associated with the industrial investment.

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1. Introduction

For the Western economies in the financial crisis from 2008, and for Japan first time in the early 2000s by a modest scale and second time from 2014 by a large scale, massive asset purchases by their central banks, which were described “quantitative” or “unconventional” against conventional interest rate intervention, became a tool of monetary policy to boost their economies. When implemented, possible channels of transmission of the policy were not precisely anticipated, because of a lack of well-established empirical works.

As time has advanced, now empirical analysis is feasible. Using the US data, [Meinusch and Tillmann \(2016\)](#) showed that the quantitative easing lowered interest rates and raised stock prices, output, and inflation. Furthermore, [Foley-Fisher et al. \(2016\)](#) showed that the quantitative easing in the US lowered bond risk premium, which relaxed financial constraints of firms. In line with this view, [Chen et al. \(2016\)](#) found that a reduction in the bond spreads was the primary channel. Using the Eurozone data, [Haitsma et al. \(2016\)](#) found that the surprises effect on the stock markets was considerable, and [Eser and Schwaab \(2016\)](#) showed that a reduction in default-risk premium was the primary channel to boost the economy of the monetary union. It has become clear that the unconventional monetary policy, often through the securities markets channel, is effective.

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Regarding which of conventional or unconventional monetary policy is effective, the evidence is less clear. Hanisch (2017) showed that, in the case of Japan, the policy impact itself was greater when conventional interest rate intervention was adopted than when the unconventional quantitative easing was adopted since 2001. Gambacorta et al. (2014) found the same tendency in all advanced economies since 2008, although it is even less clear whether advanced economies could have averted a depression in the late 2000s without the unconventional policies. Their findings are consistent with those on large spillover effects of unconventional monetary policy, which literally means that the easy money leaked, as discussed by Park and Um (2016), Fratzscher et al. (2016), Lim and Mohapatra (2016), Tillmann (2016), and MacDonald (2017).

In short, we now know that the unconventional policies were effective to boost the economy, although whether its impact be greater than that of conventional policy is not clear, that the securities market is considered to be an important transmission channel of the unconventional policies, and that the unconventional policies distort securities markets such that risk premium is lowered after implementation of the unconventional policies.

In fact, the massive securities purchases were not an innovative tool in a strict sense among major economies. The Bank of Japan adopted the corporate shares purchases program in 1890, to rein in the shock of a financial crisis, and continued the policy through the 1890s. Japan adopted the silver standard from 1885 to 1897 and the gold standard from 1897. These fixed exchange rate regimes meant a high lower bound of the conventional interest rate intervention. Touching the lower bound of the conventional policy, as central banks of advanced economies in the 2000s and 2010s have been doing, the Bank of Japan implemented a program of corporate shares purchases through rediscounting to avert the collapse of the entire financial system. We study how this very first version of unconventional monetary policy affected the two major stock exchanges then, the Tokyo Stock Exchange and the Osaka Stock Exchange, constructing a new monthly data set that includes money injection through rediscounting, and the share prices and the trade volumes of individual firms at the Tokyo Stock Exchange and the Osaka Stock Exchange from first-hand documents created by the Bank of Japan at that time but not published.¹

The rest of the paper is organized as follows. Section 2 reviews institutional contexts and historical background, Japan's first stock market boom accelerated by the banking sector in the late 1880s, its crash in 1890, and the Bank of Japan's decision to purchase shares through rediscounting in 1890, and then introduces the data. Section 3 examines how this policy affected the prices of shares on the Tokyo Stock Exchange and Osaka Stock Exchange. As it was a first innovative policy implemented by the Bank of Japan without lessons to be learned from the West, the Bank of Japan carefully tracked the effects by recording the share prices and the trade volumes. We can utilize this information with the same aim, and pin down the policy effects. Section 4 measures distortions of the both markets reflected in the equity-risk premium.

2. Bank loans collateralized by shares and the Bank of Japan

2.1. The lower bound of the monetary policy under the silver/gold standard

After toppling the Shogunate in 1868, the new imperial government promulgated the National Bank Act of 1872, modeled on the US national bank system, where each bank is entitled to issue banknotes. Then the Bank of Japan Act of 1882 stipulated that the Bank of Japan be the only issuing bank and all national banks be transformed into ordinary banks. The Bank of Japan provided these banks with base money primarily through rediscounting and overdraft. Meanwhile, until the Bank of Japan was established in the year, existing banks had formed correspondent banking system that connected one another. Through the correspondent network, the conventional monetary policy, that is, the discount rate affected the financial market.

The Stock Exchange Act of 1878 resulted in establishment of the Tokyo Stock Exchange and the Osaka Stock Exchange in the year.² The Code of Civil Procedure was promulgated and came into force in 1890, and the Commercial Code was promulgated and became effective in 1899. Along with this development, from the early 1880s, modern cotton-spinning companies and railway companies were founded as joint stock companies based on technologies brought in from the Western world. While they raised funds through share issuance and bank loans at the beginning, they replaced their bank loan reliance with bond flotation and augmented reliance on direct financing as they established a reputation in the market from the 1890s.

The Bank of Japan adopted the silver standard from 1885, where the bank committed to the conversion of the yen to a certain amount of silver on request and switched to the gold standard in 1897, where the exchange rate of the yen was fixed against the sterling pound. The commitment to the silver/gold standard imposed a serious restriction on the monetary policy. When the balance of trade went deficit, the deficit should be eliminated or capital should be imported to keep the external balance. However, in the early 1890s, Japan never issued government bonds in offshore markets and issued them only by a small amount in the late 1890s. Only after the Russo-Japanese War, 1904–1905, when Japan issued huge amount of bonds in the London market to finance the war and the Japanese government bonds became a popular emerging market asset, the flexible capital import became feasible and greatly relaxed the constraint on the monetary policy.³ The Bank of Japan did not have such a flow channel of capital import in the 1890s. It follows that the Bank of Japan needed to raise discount rate

¹ The data are available in the online version of this article at the publisher's website.

² For details, see Kobayashi (2012), pp. 73–96.

³ See Suzuki (1994), Sussman and Yafeh (2000), and Nakabayashi (2013).

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