

***Monetary and Fiscal Policy
During the Great Recession:
Old Challenges and New Insights***

Ken Kuttner
Oberlin College

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Introduction

- It has been a tough 13 years for Japan...
- ...and also tough for macroeconomists trying to understand Japan.
- What have we learned? And what challenges remain?

Outline

- Assessing the scope for stabilization policy
- Monetary policy
- Fiscal policy
- Political economy & policy institutions

Anything to stabilize?

- Was Japan hit by an adverse “demand shock” or an adverse “supply shock”?
 - If an adverse demand shock, then there’s a role for monetary and policy.
 - If supply, then policy cannot do much.
 - Inconsistent with slow growth and falling prices.
 - Some of each? How much? Why do structural problems reduce productivity?

Two monetary policy issues

- Evaluating the Bank of Japan's policies during and immediately after the bubble.
- Figuring out what to do once the overnight interest rate hit zero.

BOJ policy in the early 90s

- Still contentious.
- Most common approach to assessing Bank of Japan policy: reaction functions.
- Two sources of differences:
 - Plain “Taylor rule” (Taylor, 1993) versus Clarida et al. (2000) forward-looking rule.
 - Method of estimating potential output.

Main findings

- Policy consistent with “retrospective” output gap measure + plain Taylor rule.
- Fed policy response in 2001 was much *larger* than implied by Taylor rule.
 - Consistent with larger coefficient on output gap, as in Clarida et al. estimate.
 - The same function applied to Japan + “real time” output gap \Rightarrow much more aggressive rate cuts.

Policy at the ZLB

- Two issues arise once the central bank hits the Zero Lower Bound (ZLB):
 - The importance of expected interest rates in the *future*
 - The effectiveness of “unconventional” measures
 - Primarily quantitative easing, in Japan’s case

The role of expectations

- Conventional view: monetary policy = level of short-term interest rate.
 - No role for expectations.
- More sophisticated view: policy = rule describing interest rate response.
 - Current interest rate + expectations of future interest rate path.

The end of the ZIRP

- In August 2000, the BoJ increased the call rate to 25 bp from zero.
 - How could such a tiny rate increase have had any perceptible macro impact?
 - JBG yields fell in subsequent months — a “deflation scare.”
- A lot like the Fed’s tiny rate hike in 1937.

Policy post-2001

- Increasing reserves target.
- Commitment to zero interest rate until CPI registers a stable zero year-on-year increase.
- A marked improvement in terms of “expectations management” (at least since 2003).
- What is the exit strategy?

Monetary policy insights

- Using reaction functions to evaluate monetary policy is hazardous.
 - Sensitive to output gap estimate.
 - Lagged $\pi \Rightarrow$ slow response to disinflation.
 - Can we do better than the Taylor rule?
- Don't ignore expectations.
- Lessons (mostly) learned by Fed in its deflation-prevention strategy.

Impact of quantitative easing?

- When would quantitative easing “work” at the ZLB?
 - Via portfolio balance effects
 - Through monetization of real assets
 - If excess reserves are expected to remain *after* end of liquidity trap
- 2nd and 3rd probably don't apply in Japan, so all we've learned is that portfolio balance effects are small.

Two fiscal policy issues

- Are tax cuts and spending increases really expansionary?
- Is the fiscal situation unsustainable?

Effectiveness of fiscal policy

- Deficit growth + slow growth implies fiscal policy is ineffective... or does it?
- Slow growth is a major cause of deficit growth.
- Properly measured, stimulus *is* stimulative.
- An interesting test of “Ricardian equivalence” — seems to fail.

What is “sustainable”?

- The facts for Japan: debt burden is much smaller than often assumed.
- “Sustainable” \Leftrightarrow no long-run change in debt/gdp ratio.
- Already close to sustainability...
 - ...debt/gdp will rise sharply before it falls.
 - How high can debt/gdp ratio rise?

Political economy issues

- Was there scope for more decisive policy?
- If so, why wasn't it implemented?
 - Struggle between BOJ and MOF
 - Perverse effects of BOJ independence
 - Adherence to counterproductive doctrines
- Important implications for design of institutions, policy frameworks.

Conclusions

- Japan's stagnation has generated many valuable insights about macroeconomics and economic policy.
 - A more sophisticated understanding of how monetary policy works.
 - Evidence on Ricardian equivalence.
 - Insights on the design of policy institutions.