Comments on “Monetary Policy and Japan’s Liquidity Trap” by Prof. Lars E.O. Svensson

Kazumasa Iwata
Bank of Japan
14 September 2005,
NBER/ESRI Meeting
Model

• The model is simple, clear-cut and impeccable under the assumptions of the model.

• The core part of the paper is the direct linkage between the current exchange rate and the future price level under the zero bound on the nominal interest rate (the equation at the bottom of P.7).

• Yet the linkage may be weakened due to the changes in exogenous variables in the model such as foreign interest rates, the (time varying) natural real exchange rate and the foreign price level. This creates some difficulty to attain price-level target through exchange rate target policy (the FPW).
Practical Problems of the FPW(I)

(1) The change in expectation induced by a temporary peg may not become consistent with price-level target, due to the changes in exogenous variables.

(2) The exchange rate policy is not the policy domain for the Bank of Japan, as pointed out by the paper. The international circumstances may not allow the announcement of sizable depreciation of exchange rate, as demonstrated in the event of the Asian currency crisis. It may be noted that the yen rate during the period of the Quantitative Easing Policy remains stable, notably in nominal and real effective exchange rate (Figure 1). This makes it easier for Japan to exit from deflation.
(Figure 1) Foreign Exchange Rate

Spot Rate

Effective Rate

(Dollar / Yen)

(1973=100)

nominal (LHS)

real (RHS)
Practical Problems of the FPW(II)

(3) Taking into account of the price gap between the price-level target and the actual CPI, the required price rise is either 3-8% (starting in 2000) or 11-23% (starting in 2005), as shown in the paper. The sizable acceleration of price rise in the transition period may entail the risk of the overshooting of long-term interest rates. Given large-size budget deficit and outstanding government debt (Figure 2), the announcement to implement the price-level target may immediately destabilize the financial market and erode the efforts for steady consolidation of fiscal balance.
(Figure 2) Amount Outstanding of Public Bond and Monetary Base

(y / y % chg)

(Ratio to Nominal GDP, %)

JGB + Local Government Bond
+Monetary Base

JGB + Local Government Bond

FY
BOJ Policy and the FPW(I)

(1) The implementation of the Quantitative Easing Policy is accompanied by the widening coverage of zero interest rates and lower rates of longer maturity, due to policy duration effect. The implemented policy is equivalent to the proposal by Orphanides and Wieland (2000).

(2) The commitment to continue the QEP until the core CPI becomes stably above zero has played the role of the price stability anchor to prevent a deflationary spiral. The narrowing GDP gap worked to diminish the size of deflation from about 1% to 0% (Figure 3).
(Figure 3) Consumer Price Index

CPI excluding fresh food
CPI excluding fresh food, medical services, rice, cigarettes, petrorium products, electricity charges, telephone charges
(3) In case the Japanese economy were to fall in the deflationary equilibrium (the deflationary trap), instead of deflation induced by a temporary reduction of the natural interest rate, then it may not be sufficient to rely solely on policy duration effect on market interest rates. Yet it is important to note that the current fiscal target policy to make the primary budget deficit zero in about 8 years is active, non-Ricardian policy, because the sum of outside asset (monetary base and government debt) registers the positive rate of change (Figure 2). At the deflationary equilibrium the size of deflation is equal to the natural interest rate: then the term of \(\{(MB+B)/P\}\) increases more than the natural interest rate, then the “intertemporal Pigou effect” works to extricate Japan from the deflationary equilibrium (Benhabib, Schmitt-Grohe and Uribe(2002), Iwamoto(2004), Iwata(2005)), although the global stability is not assured in the dynamic transition process.
(4) If the core message of “history dependence” in conducting monetary policy implies that the more expansionary policy should be adopted at the point close to the exit, the current monetary policy is broadly in line with the spirit inherent in the price-level target policy, because of the increased degree of excess supply of bank reserves and the negative real interest rates reflecting the positive expected inflation rate in the various surveys.
Conclusion

• In view of the success to bring the Japanese economy to virtually zero inflation rate from about 1% deflation, we can have good prospects to overcome deflation by adopting the step-by-step approach based on the price stability anchor implicit in the commitment on policy duration to reach the normal equilibrium.