Comments for Session 4: Spillover Effects of Economic Policies

by

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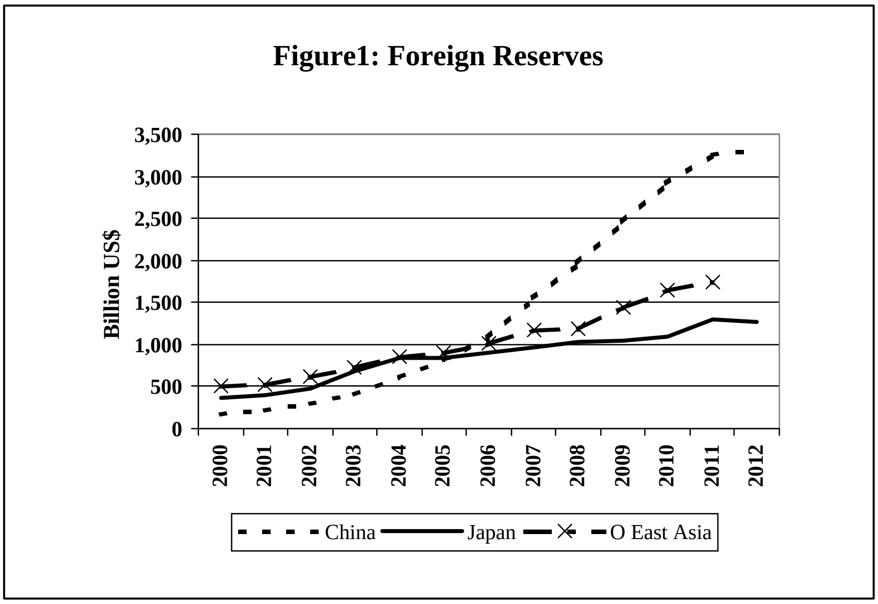
Let me start my comments by saying that I am very impressed by the resoluteness of Prime Minister Shinzo Abe in pushing for a new direction of economic policies for Japan, so called “Abenomics”, particularly the adoption of very strong monetary easing with the aim of achieving 2% inflation target in the medium term and bringing Japan out of an extended period of deflation and stagnation. Having been Finance Minister of Thailand in the past, I know that such a change in direction takes very strong political will and strong sense of responsibility, particularly when there are diverse opinions about the consequences for the Japanese economy of such a change in policy direction. Market reactions to Abenomics have been substantial, with large depreciation of the yen against all major global and regional currencies and Japanese stock prices have risen by 40-50% since Prime Minister Abe took office. There seems to be a renewed confidence within Japan about prospects for the Japanese economy and first quarter GDP growth at an annualized rate of about 3.5% provides some evidence that growth is picking up. However, volatilities in the stock and bond markets in the past week or so may be signs that things will not be all smooth sailing for Abenomics and the Japanese economy, and delicate policy navigations will be needed to weather potential episodes of financial market shocks and volatilities and take Japan back to a sustained growth path.

Professor Ito’s paper focuses on the yen depreciation in relation to possible accusations that Japan is engaging in currency manipulation or a currency war. My interpretation of his message is that the yen has been recovering from a period of post Lehman Brothers’ strong yen appreciation during which Japan mostly stuck to conventional monetary policies while unconventional monetary policies were being pursued vigorously elsewhere. Figure 3 in his paper showed that the Bank of Japan’s balance sheet had hardly increased since the start of the global financial crisis while those of the US Federal Reserve, the European Central Bank and the Bank of England have increased 2 to 5 times. The increased liquidity of the other major currencies contributed to large appreciations of the yen.

It seems to me that the pursuit of rather conventional policy also extends to Japan’s exchange rate policy, where here “conventional” refers to little or no foreign exchange market intervention. Japan has intervened relatively little in the foreign exchange market since 2004. In contrast, many East Asian economies have actively intervened in the foreign exchange markets, both to prevent their currencies from strengthening too much and also to increase self insurance against rapid capital outflows, such as occurred after the closure of Lehman Brothers. This can be seen in figure 1, which shows the accumulation of foreign exchange reserves of China, Japan, and other East Asian economies.[1]



In the past, I have asked Japanese officials and academics many times, particularly after the onset of the global financial crisis, why Japan kept sticking to very conventional, almost textbook like, monetary policies when most major countries of the world were resorting to unconventional policies. The impression I got, whether rightly or wrongly, was that there is a sense of pride for Japan, as a major global economy, to pursue conventional policies and set a good example for other economies. This is very commendable, but in a world where most other economies are rewriting the rulebook to justify unconventional policies as the new normal, rigidly sticking to conventional policies may bear very high costs. So Japan is now catching up with some of the unconventional policies that others have pioneered, as well spelt out by Professor Ito.

While most countries are grudgingly accepting that Japan is catching up to unconventional policies that others have been using before, and there have been

[1] Other East Asian economies include ASEAN, South Korea, Hong Kong and Taipe,China. Data from World Bank, World Development Indicators and Asian Development Bank, Key Indicators for Asia and the Pacific.

expressions of understanding of Japan's situation and no outright condemnation at meetings such as the G-7 or G-20, there are obviously concerns about where things might be heading. Professor Sapir's paper summarized some of the European perspectives. The sense I got from his paper is that European policy makers are carefully monitoring the outcomes of Abenomics. As trade between the EU and Japan is a rather small proportion of GDP, the yen depreciation is unlikely to have a large impact via relative trade shifts. However, a continuing trend of increasing liquidity of the US$ and the yen could shift the burden to the euro, and this would have a much larger effect on the Eurozone. If the euro ends up appreciating significantly against other currencies, and if yen liquidity injection can lead to Japan's economic recovery, the Eurozone may have no choice but to follow suit. Would this then be a genuine global currency war?

Professor Sapir also raised the issue of at what level the yen might reach. This is obviously very important, as other countries might be able to accept a yen level of about 100-110 yen per US$ as going back to the pre-unconventional monetary policy era, but if the yen went to 120, 130 or even 150 yen per US$, would this still be regarded as acceptable? It would be highly unlikely. An important issue is whether the Bank of Japan and the Ministry of Finance have sufficiently policy instruments to target particular ranges for the yen. This is not easy to do in the case of a major currency with huge amounts of market trades. Much depend on market expectation and also speculation, and managing market expectation and speculation is one of the most challenging tasks of monetary policy.

The yen depreciation and resulting stock market boom has benefited Japan's real economy through exports (including tourism) and increased domestic consumption. Managing inflation expectation to the 2% target may boost domestic expenditure further. However, I still cannot rid my mind of a phrase that was drummed into me when studying economics many years ago that "there is no free lunch". May be in the modern world, lunch is freer, but I think there are still considerable challenges for managing Japan's monetary policy that need to be faced. One is the relationship between inflation expectation and long-term interest rates? If investors really believe in the 2% inflation target, and market reactions to Abenomics suggest that market participants believe in the credibility of the policy, then long-term rates, say on 10 year JGBs, may tend to rise near to the expected inflation, which will be a big jump compared to current levels. The market values of outstanding long-term bonds will decline substantially. What will happen to the holders of these bonds, particularly financial institutions? To keep yields down, the Bank of Japan may need to continue to buy more and more JGBs. But then how to keep the yen exchange rate in check and also make sure that inflation remains around the 2% level and not get out of hand. I am not saying that these challenges cannot be managed, but these problems need to be anticipated and appropriate institutional operational mechanisms, particularly between the Bank of Japan and the Ministry of Finance, put in place to monitor and react quickly to potential problems with appropriate policies.

Finally, I just want to mention that monetary easing by the major economies of the world also lead to a lot of spillovers and policy challenges for emerging market economies, particular ones like my own country, Thailand, with relatively open capital accounts. Excess liquidity of the major international currencies lead to large and volatile capital flows to emerging markets to seek higher returns. Because of the relatively small size of emerging markets, moderate flows can lead to large swings in exchange rates and asset prices. Thailand has faced many episodes of large capital inflows, going back to well before unconventional monetary policy became fashionable, leading to excessive exchange rate appreciation with negative impacts on exports, and the past six months or so is another one of such episodes. There are many constraints on the central bank in managing such episodes. Exchange rate intervention and sterilization can lead to large losses for the central bank and can have fiscal implications. There can be vastly different points of views on the appropriate direction for interest rates, with open conflicts between various agencies. Many countries are still struggling with the most appropriate policy combinations to deal with these capital flows. It seems likely that unconventional policy measures on capital flows, or some form of capital controls, need to be part of the policy toolkit, but these need to be thought out and designed carefully. The Thai experience with capital controls that were introduced in December 2006 was not a good one. But more targeted capital control measures, such as those introduced by Hong Kong and Singapore several months ago to cool down the real estate market seemed to have worked. So, this appears to be an age where unconventional policy measures in many areas are the new normal. This should raise a lot of questions for the more conventional economists to think about.