Japan’s monetary authorities must act more aggressively

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By Kumiharu Shigehara

In his most recent speech, Donald Kohn, vice-chairman of the US Federal Reserve, said that the Fed had learned that the aftermath of a bubble can be far more painful than it had imagined.
He then carefully examined alternative strategies for monetary policy to deal with asset price bubbles. However, he did not specifically discuss a potential role of foreign exchange rates in the aftermath of a bubble in supporting aggregate demand through their influence on exports.

In fact, a number of Organisation for Economic Co-operation and Development countries which suffered from domestic asset market declines in the late 1980s or early 1990s, experienced large currency depreciations as a result of a loss of market confidence in their economies. The resulting strengthening of international price competitiveness led to a sharp upturn in exports and helped the recovery of overall output activity.

In contrast, the Japanese yen followed an uptrend even after the burst of the bubble in early 1990s. Between the end of 1990 and April 1995, the yen appreciated against a basket of currencies of its trade partner countries by 64 per cent. As a result, Japanese export volumes either declined or grew at a pace far below the growth of its markets each year, leading to a sharp decline in Japan’s share in the world export market. Thus, net exports made a negative contribution to gross domestic product growth. Nevertheless, Japan somehow maintained positive GDP growth with fiscal and monetary support to domestic demand growth. The yen’s reversal started in the second half of 1995 and by April 1997 its effective rate declined by 24 per cent relative to the peak of April 1995.
A rebound of the yen took place in the second half of 1997. It coincided with a sharp tightening of fiscal policy and the outbreak of the crisis in emerging Asian economies, which was followed by the

sudden collapse of several Japanese financial institutions late that year. With weakened business and household confidence and their spending, Japan recorded a 1.1 per cent decline in real GDP in 1998, the first negative growth since the 1974 recession in the aftermath of the first oil crisis.

In a lecture given at Harvard University in 2001, Allan Meltzer, professor of political economy at Carnegie-Mellon University, commented on this episode: “Japan’s problems are mainly homemade. Mainly, but not entirely. The US Treasury had a role, too. It recommended publicly…that Japan should rely on fiscal stimulus and avoid sufficient monetary stimulus to depreciate the yen/dollar exchange rate.”

The recent sharp yen appreciation against the US dollar, euro and other currencies including those of emerging Asian economies has considerably weakened Japan’s international price competitiveness. With a 22 per cent appreciation of the yen’s real effective exchange rate from mid-2007 to October 2008, it is now more than 11 per cent higher than the level of March 1973.

Recent large declines in the dollar prices of oil and other commodity prices coupled with a sharp yen rise have started to exert strong downward pressure on Japan’s average import prices in yen. Moreover, incoming data indicate that the Japanese economy has already entered its first recession in seven years, and that slack in the economy will most likely widen next year. Unless further expansionary domestic policy action is taken and/or significant yen exchange rate correction occurs, Japan will likely start to experience deflation much earlier than recently forecast by the OECD.

The sharp appreciation of the yen against the US dollar, euro, the British pound and other leading currencies reflects a considerable narrowing of interest rate differentials between the Bank of Japan policy rate and those of the Fed, the European Central Bank, the Bank of England and other

central banks. Most of the latter reduced them far more aggressively and by larger cumulative amounts given their higher initial levels, while the BoJ limited its cut to 0.2 percentage points.
At the same time, the Bank started a system of paying interest on excess bank reserves held at BoJ accounts, thus effectively providing a floor to interest rates in the overnight interbank money market.

In fact, interest rates on term money instruments have risen since the cut in the BoJ policy rate, with a widening of interest differentials between overnight and term monies, thus negating the policy effects on longer-term interest rates more relevant to borrowing costs of private enterprises and households. Moreover, availability of credit to the private non-bank sector is being reduced with the more cautious lending attitude of banks whose capital bases have been weakened by declines in the market values of their equity holdings as well as the yen values of foreign currency assets.

Given this situation, more aggressive action by the Japanese monetary authorities is urgently needed.

First, the BoJ should stop provision of dollar funding to banks in Japan in need of dollar funds, and encourage them to borrow yen funds from the BoJ, letting them obtain dollar funds by selling yen in the foreign exchange market.

Second, the Japanese authorities should take appropriate direct action in the foreign exchange market, following the statement of G7 finance ministers and central bank governors on October 27, which specifically expressed concern about the adverse effects of recent yen movements.
Now that an extremely sharp turnaround has taken place, the authorities must not hesitate to intervene in the foreign exchange market as appropriate, in particular to smooth out volatile

movements, with a clear commitment to conduct reverse operations to net out their balances over a reasonable, but unspecified time span as foreign exchange market conditions settle down.

Third, the BoJ should go quickly back to the earlier regime of zero-interest rate and to "quantitative easing". Some simulations with econometric models suggest that the macroeconomic effect of moving to a regime of zero-interest rate and to the "quantitative easing", measured essentially through the term structure channel, was very small. However, "quantitative easing" may also influence foreign exchange and stock market conditions. A change in asset market prices will change the market values of banks' equity holdings as well as the yen values of their foreign currency assets, thereby affects bank capital adequacy which can then influence credit availability. Macroeconomic effects through these transmission mechanisms can be significant, though it is not easy to incorporate the working of these mechanisms in econometric models.

As Mr Kohn said, central banks need to improve their understanding of the workings of the financial system, its vulnerabilities, and its links to the real economy. The BoJ does not have the luxury of waiting for the results of rigorous empirical work before taking action.

Well-considered measures should be taken quickly as an insurance policy, given downside risks to the domestic financial systems and the real economy.

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November 25th, 2008 in Asset price bubbles, Federal Reserve, Foreign exchange rates, Japan, Recession, Yen appreciation | Permalink

13 Responses to "Japan's monetary authorities must act more aggressively"

Martin Wolf: I disagree somewhat with this interesting and important post. In current circumstances, it seems to me that the surplus countries, including Japan, should expect their exchange rates to appreciate. They must also rely far more on domestic demand, rather than foreign demand. Meanwhile, the deficit countries, particularly the US and the UK, need to eliminate the external deficits and so export their way out of trouble.

In deficit countries either the private sector, or the public sector, or both, must, by definition, spend more than its income. In other words, they must run a financial deficit. To do so, they must sell financial claims. In the case of the government and the household sector (which have been the principal borrowers in the US and UK in recent years), this means selling debt. But the financial crisis has destroyed the possibility of sustaining the financial deficits of the private sector. Households, in particular, are far too indebted. They need to increase their savings, instead.

In the short run this means an explosion of fiscal deficits to levels that will be unsustainable in the long run. The only way out of this is for these countries to move sharply towards a current account balance. That would also allow the household sector and the government to shift towards financial balance - i.e. to stop net borrowing.

If the US and UK are going to move towards balance, someone else must move in the opposite direction, while maintaining output in line with potential. The best positioned countries are those with already large surpluses. The reduction of the surpluses of oil exporting countries will help in the short run. But I do not expect oil prices to stay down when the world economy recovers. In the longer term, therefore, structural surplus countries, such as China, Germany and Japan, will need to shift away from reliance on net exports. The suggestions by Kumiharu Shigehara seem to go in the opposite direction. The argument must be that Japan cannot absorb its domestic savings. I am unconvinced. The bulk of Japan's savings are the retained earnings of corporations, which are substantially in excess of corporate investment. These retained earnings should be paid out in dividends or taken in taxes. Either way, they should be consumed.

Japan's consumption is still too low and its savings too high. The principal aim of fiscal policy should be to promote consumption, not conserve savings, on which the returns at the margin are desperately low, if not negative.

In essence, I am making two points. First, Japan cannot expect, once again, to export its way out of the trouble caused by its chronic failure to develop domestic demand. Second, the principal answer is to reduce savings and promote consumption.

Posted by: Martin Wolf | November 25th, 2008 at 8:40 pm **|** Report this comment

Kumiharu Shigehara: What is striking in the OECD's new forecasts (see Table 1.7, page 44 of OECD Economic Outlook 84, published on 25 November, which Martin may not have seen) is a contrast in terms of the contribution of net exports to GDP growth between Japan on the one hand and the US and the Eurozone on the other: while the OECD predicts a net positive growth contribution from net export volumes for the latter, Japan's net export volumes are projected to make negative contributions amounting to 0.7 percentage point of real GDP in 2009 and a further 0.4 percentage point in 2010. In other words, the projected increase in the OECD area's net export volumes in the coming two years will benefit essentially the US and the Eurozone.

Thus, Japan will stand alone as a country not benefiting from non-OECD market growth. Declines in her net exports will more than offset the positive GDP growth effect of domestic demand expansion, resulting in a 0.1 per cent contraction of output next year. Yen depreciation from current levels consistent with no changes in Japan's net export volumes in the coming two years (rather than declines as projected by the OECD) will definitely be compatible with the shared goal of avoiding a “beggar-thy-neighbour’ policy.

The OECD predicts German current account surpluses amounting to 6.2 per cent and 6.1 per cent of GDP in 2009 and 2010. Equivalent numbers for Japan are 4.3 per cent and 3.9 per cent. Following Martin’s argument, should we suggest that the current account surpluses of Germany, a country which is in a sense protected by the euro, be reduced at least to Japan’s levels in the coming years by fiscal boost?

Posted by: Kumiharu Shigehara | November 26th, 2008 at 2:58 am | Report this comment

Andrew Smithers: Michiyo Nakamoto’s FT article on Japan illustrates with sad clarity how difficult it is to get a serious discussion going about Japan’s economy. This is not a criticism of Michiyo’s article, which accurately represents the views of those to whom she talks, but a criticism of the stockbroking community’s refusal to recognise that Japan has a large and persistent structural imbalance.

The country invests 24 per cent of gross domestic product, of which 16 per cent is in private non-residential fixed investment, compared with the US’s 10 per cent. Given Japan’s demography, it has a trend growth rate which has been and is likely to remain well below that of the US.Even allowing for underinvestment by the US and UK, the Japanese level is clearly excessive, as it results in an ICOR which is three times worse than that of the US or UK and twice as bad as that of France and Germany.

Japanese investment is inefficient in terms of both the return on capital and economic welfare. Over-investment has been due to: (i) management indifference to the interests of shareholders, (ii) low interest rates and (iii) the higher capital/output ratio of exports compared with domestic demand. As Japan's export markets (including China) contract, the chronic problem is becoming acute. Japan needs a large switch in demand from investment to consumption.

This is difficult, but by no means impossible; it is, however, unlikely to be achieved unless the problems of the economy are faced and discussed. First and foremost it must be recognised that the economy is demand rather than supply constrained.

Michiyo's article shows how difficult this is, as those to whom she talks were almost exclusively concerned with issues of supply such as (i) how to improve productivity in agriculture or (ii) ditto services or (iii) through embracing globalisation, or (iv) deregulation or (v) "reform" or (vi) encouraging mergers.The implicit and unrecognised assumption behind these views is contrary to the generally accepted views of economists that Saye's Law applies, i.e. that supply creates its own demand.

Even when boosting demand is mentioned it is either a trivial, and apparently now postponed sop, of ¥2 tn (0.4 per cent of GDP) of "cash hand-outs designed for low-income families" or "to support domestic demand through labour market reforms" (supply again) or "corporation tax cuts", which no rational person can imagine to be designed to encourage consumption.

Several issues and confusions have served in the past to make the discussion of Japan's problems particularly difficult.(i) An historic and cultural tendency to distrust consumption, particularly when it seems ostentatious. This accounts for the attitudes shown in the article. When demand needs stimulating, as it does today, discussion gets readily switched to issues of supply and, despite the need to boost consumption, preference is readily given to investment.(ii) While the stock of household savings is high, the current rate is low (3per cent of disposable incomes having come down from 11% in 1997.)The problem is not how to persuade the Japanese to spend their savings, it is how to increase consumer incomes so that they can afford to spend more. Household disposable incomes in Japan are much lower, as a proportion of GDP, than in other G5 countries

(59 per cent in Japan compared with over 65 per cent for the US, UK, France and Germany.)(iii) The national savings' rate is confused with the household rate. The latter is low and the former high, due to the high level of gross corporate savings, which is, however, mainly in the form of depreciation rather than retained profits. Japan has managed to grow, albeit weakly, since its bubble burst in 1990, but the driving force has been exports and their associated investment. This depended on rising demand in the rest of the world.

If, today, Japan looks again to the rest of the world to bail it out, it is likely to be disappointed and, because investment is such a high proportion of GDP and so sensitive to exports, Japan's economy is just as vulnerable as other G5 countries to the world downturn, even though it does not suffer from the excessive household sector debt levels that bedevil the anglophone economies.

Household savings are likely to rise in the UK and US and will need to do so, while private sector domestic investment will remain weak for some time ahead. Fiscal stimulus in the US and UK alone will not bail out the world. They need to reduce their current account deficits. Surpluses elsewhere, including those in the Far East, will need to be reduced, through rising demand for imports not just through weak exports.

While this is often understood, the attention is generally on China, but Japan is more important being the second largest economy in the world and currently much bigger than China. It is very important for the world economy that Japan's structural excess investment and under-consumption are discussed rather than ignored and that this leads to Japan boosting its domestic demand so that the country does not rely on countries with large current account deficits taking the vast bulk of any effective action.

In the shorter term a boost to Japanese consumption must come from a rise in the fiscal deficit. In the longer term it must come at the expense of profits, through rises in the labour share of output and in interest rates. Lower investment will lead in time to lower corporate depreciation, which will soften the longer term impact on profits, after depreciation, that will come from the needed rise in the labour share of output. The government might usefully speed up this process by instituting a special tax allowed one-off write-down in the value of corporate plant and equipment. Without better discussion leading to better action, we will see a steady drift to protectionism.

Posted by: Andrew Smithers | November 28th, 2008 at 6:00 pm | Report this comment

Kumiharu Shigehara: Most of Andrew Smithers' remarks deal with Michiyo Nakamoto's article on Japan and are not related to my article which specifically deals with issues related to Japan's monetary and foreign exchange rate management. So, I would not discuss them in detail here. This does not mean that I do not consider Smithers' specific points are all wrong or unimportant, but they should be discussed somewhere else. Otherwise, our discussion here risks diverting from the main macroeconomic issues raised in my article.

En passant, I would nevertheless point out that raising productivity and return on capital in particular in construction, services industries, agriculture and some other sectors through structural reform working on the supply side is crucial in Japan which suffers from a growing structural shortage of labour supply with the a rapid ageing of population and a low fertility rate as well as linguistic and other barriers to greater reliance on foreign immigrants as a source of labour supply.

That said, I would make some observations on Smithers' remarks in the macroeconomic area.

First, Smithers noted that Japan invests 24 per cent of gross domestic product, of which 16 per cent is in private non-residential fixed investment, compared with the US's 10 per cent. In fact, private non-residential fixed investment in Japan was as high as 23 or so percent of GDP in the bubble period of the late 1980. I then argued that it was too high and bound to decline. However, I cannot definitely say, as Smithers does, that the current level of 16 percent is “clearly excessive”.

Second, Smithers asserts that Japan needs a large switch in demand from investment to consumption. Here, I argue that, given the already very high level and good quality of Japanese private consumption in general, it would be unwise, for non-economic considerations such as environmental protection (note, for example, that Japan imports high-quality fresh fish and other growingly rare natural resources from all over the world for domestic consumption) to boost private consumption artificially.

Third, Smithers asserts that ‘First and foremost it must be recognised that the economy is demand rather than supply constrained’. According to the OECD, output gaps (measured as deviations of actual from potential GDP as a percentage of potential GDP) is estimated to be zero in 2008 and will turn to -2.5 percent in 2009 for the total OECD area, and -0.4 per cent and -3.8 per cent respectively for the US, whereas the equivalent numbers for Japan are 0.9 per cent and -0.4 per cent. In my view, an attempt to close the output gap amounting to 0.4 per cent of Japan’s potential GDP in 2009 (as forecast by the OECD) by sole reliance on fiscal measures to boost private consumption is economically, socially and ecologically undesirable. Public works for environmental protection, medical care and educational facilities as well as public R&D spending should be enhanced.

Fourth, turning to the issue of achieving a more sustainable external position of the US, we of course need not only US moves towards raising its national savings on a cyclically-adjusted basis, but also adjustment by its partner countries. However, such adjustment should not necessarily require reductions in non-US countries’ national saving ratios. Higher public investment for environment protection, better social care and so-forth in these countries would also help reduce external imbalances between the US on the one hand and large current account surplus countries such as Japan and Germany in the OECD area and emerging economies in East Asia on the other.

Finally, I entirely agree with Smithers who finished his remarks by noting: “Without better discussion leading to better action, we will see a steady drift to protectionism.” We must definitely prevent it.

Posted by: Kumiharu Shigehara | November 29th, 2008 at 7:22 am | Report this comment

Martin Wolf: Andrew has added great strength to my arguments. I agree with him entirely. The Japanese really need to start thinking about what is good for their economy and, no less, how it fits into the world. They cannot - repeat cannot - assume that the rest of the world will be able to absorb savings surpluses any more.

Posted by: Martin Wolf | November 29th, 2008 at 3:09 pm | Report this comment

Kumiharu Shigehara: Arguments by both Martin Wolf and Andrew Smithers are impressionistic, not solidly based on statistical evidence. Their views are similar to those we often heard from British and Nordic economists in the 1980s when Japan and Germany ran sizeable current account surpluses while the US, the UK and some other European countries had external deficits. Then, most of them argued for fiscal action to boost consumption and reductions in household savings.

Household saving ratios in both Japan and Germany were indeed very high in the 1980s. However, more recent financial indicators show that Japanese household saving ratio has dropped dramatically over the 1990s onwards. Martin Wolf and Andrew Smithers are invited to look closely at pages 111 and 121 of OECD Economic Outlook No. 84, Preliminary Version, published November 2008. According to the tables shown there, Japanese household saving ratio is as low as 3.3 per cent of its disposable income in 2008 and is forecast to decline further to 3.2 per cent in

2010, whereas the German ratio is forecast to rise from 11.6 per cent in 2008 to 13.0 per cent in 2010.

We economists must base our policy discussion on objective analysis as much as possible rather than on impressionistic and distorted views. In fact, what is rather unusual in the domestic savings and investment balances of Japan nowadays is a high corporate saving ratio, and not its household saving ratio which is indeed not so much different from the US household saving ratio (2.8 per cent in 2009 as predicted by the OECD). Note also that the Japanese corporate sector's high domestic savings are significantly matched by its huge net foreign direct investment outflows. With complete liberalisation of private capital transactions and the growing importance of direct investment abroad by Japanese business enterprises, it does no longer make sense to discuss the sustainability of external balances and imbalances focused solely on current account positions. Imbalances in terms current account balances adjusted for net foreign direct investment flows should be a more useful measure in the new situation, although I would hasten to add that the sustainability of US external positions should be analysed using many other indicators as well.

Elsewhere in the FT Economists Forum, I asked Martin to express his views on German current account surpluses (6.4 per cent of GDP in 2008 and 6.1 per cent in 2010 whereas the equivalent numbers for Japan are 3.8 per cent in 2008 and 3.9 per cent in 2009, see page 98 of the OECD Economic Outlook noted above), and how he thinks German current account surpluses should be reduced, if he thinks that is desirable, following the arguments he put forward for Japan.

To facilitate our discussion on a more solid ground and to draw policy implications for Germany as well as for Japan and for the rest of the world, I would now like to ask Martin to respond to these questions of mine here in this section.

(Let me finish by adding that I have enjoyed discussions here with both Martin and Andrew. To any further responses from them or from other Forum participants, I shall come back with my reactions on return to Japan from abroad at the end of this week, hoping that this section will be kept on the FT website. Actually I am travelling and I do not have free access to Japanese statistics.)

Posted by: Kumiharu Shigehara | December 2nd, 2008 at 4:24 am | Report this comment

Kumiharu Shigehara: Just to add that BoJ has just published new data on the yen's real effective exchange. According to its measure, it rose further by 7 per cent in a single month of last November to reach a peak 17 per cent above the March 1973 bench mark level.

Posted by: Kumiharu Shigehara | December 2nd, 2008 at 5:07 am | Report this comment

Martin Wolf : I thank Kumiharu Shigehara for his additional comments. I hope to respond soon. In the meantime, he will presumably be outraged by the column published this evening.

Posted by: Martin Wolf | December 2nd, 2008 at 7:33 pm | Report this comment

Andrew Smithers: In my posting dated 28th November, I used Michiyo Nakamoto's article to illustrate the difficulty of airing a serious discussion about Japan's economy. This is due to a common refusal to discuss the problem of insufficient demand and, by implicitly assuming that Say's Law holds, that attention should be concentrated on supply issues. Kumiharu Shigehara has responded to my comments by exemplifying the attitudes I criticise.

(i) He first remarks that he cannot definitely say that Japan's 16% business investment ratio is "clearly excessive", and ignores the evidence I presented that this is shown by the fact that Japan's ICOR has been three times worse than that of the UK and US and twice as bad as that of France and Germany. The result is an abysmal return on new capital. As Japan's growth rate has been so poor, despite such high investment, it is probable that it would have been barely, if at all, worse had investment been lower. If investment can be switched to consumption without any loss of growth, the welfare of the Japanese people would improve as, at any discount rate, the present value of current and future consumption would rise. It would also rise at any reasonable discount rate if even a small loss of growth was involved.

(ii) Shigehara then argues against such a switch from investment to consumption on the grounds that the latter is already high and of good quality and that higher consumption would be bad for the environment. But investment is worse for the environment than domestic consumption, given the high service element in the latter. In any event, tax policy is the sensible way to deflect demand to environmentally friendly activities. I would note that the observation that rich Japanese consume much more than poor ones is incompatible with the implied claim, recently made also by Economics Minister Yosano, that Japanese people have no desire to spend more.

(iii) Shigehara then argues that demand does not need boosting because the OECD estimates that Japan will only have a small output gap in 2009. I hope he will excuse me for finding this argument improbable. In addition to the high uncertainty of any output gap estimates, as shown, among others, by Orphanides and van Norden in their paper "The Unreliability of Output Gap Estimates in Real Time" (CIRANO Montreal November 2001), Japan has already had two quarters of falling GDP. Industrial production and nominal wages are falling and unemployment is rising. Japan has an output gap and it is rising rapidly.

(iii) He next argues that, while lower current account deficits in the US need to be balanced by lower surpluses elsewhere, this should be done by higher public investment but not by sole reliance on fiscal measures to boost consumption. Higher public investment will not boost demand unless it involves an increased fiscal deficit. If the Japanese people prefer higher government spending to tax cuts as the route to a large fiscal deficit, that is their choice. What matters to the world is a higher deficit.

(iv) In a subsequent posting Shigehara argues that Martin's and my views are impressionistic, not solidly based on statistical evidence. In support of this he invites us to look at the Japanese household savings' rate in the OECD's Economic Outlook Vol 84. at 3.3% in 2008. As I quoted the same figure and my analysis was based on the available statistical evidence, I think the boot is on the other foot. As I have pointed out above, it is Shigehara who is ignoring the statistical evidence. I would ask him to read what I write before claiming that I am ignorant of the statistics that I quote.

Martin and I clearly agree and this applies also to his article in today's FT. Germany and Japan both benefitted in the post-war era from the stimulus given by the US and UK through fiscal boosts when world demand weakened. They were free riders. I doubt whether this is any more workable, let alone acceptable.

As an aside, I fear that Martin is too optimistic in his belief that the high Japanese savings' rate can be materially reduced by increased dividends. The high savings' rate of Japanese companies is almost wholly due to high levels of depreciation reflecting past over-investment. This is why I suggest that a tax financed write-off of produced assets in corporate balance sheets might ease the switch from investment to consumption that Japan and the world so badly need.

Posted by: Andrew Smithers | December 3rd, 2008 at 2:50 pm **|** Report this comment

Kumiharu Shigehara : I thank both Martin Wolf and Andrew Smithers for their additional provocative comments which I have just managed to read. I am actually traveling in Europe and have some difficulty in internet connection, so I hope to respond after my return to Tokyo.

Posted by: Kumiharu Shigehara | December 4th, 2008 at 12:28 am **|** Report this comment

Kumiharu Shigehara: Our debates have strayed somewhat from the main macroeconomic policy issues I had raised and discussed in my initial article. I suggest that in this section of FT's economists' forum we should focus on monetary policy and foreign exchange rate issues, since, indeed, it was concern about insufficient demand (and in particular domestic demand weakness which I shall discuss further below), that led me to title my initial article "Japan's monetary authorities must act more aggressively".

The main reason why my initial article focused on monetary policy and foreign exchange rate issues, and not on fiscal policy issues, was that the former two were neither explicitly dealt with in the recent G20 political leaders' communiqué nor in macroeconomic policy discussion in Japan where in the light of growing signs of worsening business conditions, there have been many debates about the extent to which fiscal stimulus should be added and what form it should take. Initially designed as a contribution to a newspaper column in Japan (published by the Nikkei Weekly of 1 December), my article was written specifically to provoke discussion on these two rather neglected aspects of macroeconomic policy management since debates in Japan have been pursued essentially in the framework of a closed economy.

I put forward my article also to the FT's economists forum, because monetary policy changes can have important international ramifications and, depending on the way it is conducted, can become an instrument of "beggar-thy-neighbour" (I prefer the French expression "chacun pour soi" to this English one) policy.

I do think that in the current fragile global financial and economic situation, the conduct of not just fiscal policy in all major countries but also monetary policy and its interaction with exchange rate developments must be closely examined at bodies for multilateral surveillance in particular at the meetings of the Organisation for Economic Co-operation and Development working party No.3 of the economic policy committee (a gathering of vice-finance ministers and central bank deputy governors of a selected number of OECD member countries together with the International

Monetary Fund, Bank for International Settlements and European Union representatives) and the G20 meetings (at the level of vice-finance ministers and central bank deputy governors). But, informal fora such as the FT's economists forum could also play a useful role.

Let me now make additional and specific comments on monetary policy and foreign exchange rate issues in Japan, on the basis of statistical and other materials which became available to me on return to Tokyo over the past weekend.

First, I have now learned about the latest medium-term projections of the Japanese economy prepared by the Nihon Keizai Research Center and published on December 4. The Center forecasts declines in net export volumes will have small negative contributions to Japan's real gross domestic product growth in each of the next three years.

Second, the OECD forecasts for the Japanese economy published in late November, which I used in my earlier remarks are now less useful, in particular as exchange rates for 2009 and 2010 are assumed to remain unchanged at the October 28, 2008 levels. The yen's real effective exchange rose further by 7 per cent in a single month of last November to reach a peak 17 per cent above the March 1973 benchmark level. The yen continued to rise in the first week of this month.

Third, both the OECD and the Center predict a contraction of domestic private demand, with the Center forecasting a negative 0.9 percentage point contribution to real GDP growth far more than offsetting a positive contribution of public expenditure amounting to 0.3 per cent of real gross domestic product.

Given this, I continue to argue that on top of a fiscal boost, the Bank of Japan must act more aggressively, rather than keeping its policy rate at 0.3 per cent. The BoJ's more aggressive monetary easing to support domestic private demand, which may lead to some correction of the recent sharp real appreciation, resulting in somewhat smaller negative contributions of net export volume changes to real GDP growth or no changes (rather than increases) in net export volumes is not a "beggar-thy-neighbour" policy.

Posted by: Kumiharu Shigehara | December 7th, 2008 at 9:15 pm **|** Report this comment

Kumiharu Shigehara: Readers of this section in the FT's Economists' Forum might be in interested in the comments (see below) I have received from a former OECD colleague of US nationality with long experience in the fields of international macroeconomic policy co-operation and international banking issues. He has agreed to my posting it here.

Comments from Paul Atkinson to Kumiharu Shigehara (7 December 2008)

This correspondence has become very diffuse, especially with Andrew Smithers, touching on a variety of issues, some of which are only peripherally related to monetary management: total domestic demand vs. net exports; the composition of total demand; savings and investment imbalances and how they should be absorbed; efficiency of investment and usefulness of supply side policies; etc. I think the issue is how do we achieve your "shared goal of avoiding beggar-thy-neighbour policy" (your response to Martin Wolf) in the present context with interest rates approaching zero nearly everywhere, the money/credit system barely functioning, every one slowing sharply and appropriate candidates for currency appreciation hard to identify (small oil producers do not suffice)I think you deflect Martin Wolf's "persistent user of beggar-thy-neighbor policies" charge effectively, which I gather he has acknowledged.

I don't find his argument that saving surpluses, mainly in Asia, are the main source of the current crisis entirely convincing. A "savings surplus" is an odd variable to focus on. It is neither policy instrument nor private sector behavioral parameter, it is highly endogenous and its counterpart in investment is a mix of real capital and external net asset/liability acquisition.

I am comfortable with his focus on macro distortions rooted in Asia, but the emphasis would better on exchange rate manipulation, reflected in rising official reserves (which I think has continued until recently in China, even though Japan stopped several years ago), rather than "savings surpluses". It is this that reflects conscious policy choice and which could be modified at will.

The failure of the dollar, until late 2007, to fully reverse the appreciation it experienced during the tech boom and the emerging Asia's crisis of 1997—1998 conditioned the policy choices facing the Fed during the recent expansion. We criticize Alan Greenspan now, but for years the debate was how to deal with potential deflation in a context of weak or falling import prices and the drag on domestic output from very negative net exports. The result was very heavy reliance on monetary policy to stimulate demand (offsetting negative net exports), which in practice favored housing. For all the excesses, the recent upswing was the weakest I can remember in the US.

I think it is a priority for the US either to gain control over its exchange rate as a policy instrument or to arrange for it to be market determined. We can live with smaller countries manipulating their exchange rates for their own ends. But, even if Japan continues to allow the yen to be market determined, China and other emerging Asia collectively are too large and important to behave in systemically damaging ways. Exchange rate arrangements and their management in Asia seem to me the main global macro issue that needs to be addressed once the current crisis has passed.

More fundamentally, none of theses macro distortions necessitated a crisis like we have. Many forces operated, a bit of a "perfect storm", but the overriding factor in my view was the regulatory failure that allowed, even encouraged, the excesses of leverage and lack of capital in the financial system. Real estate booms and busts are not new, and all sorts of things can lead to other asset impairments. With a sensible amount of capital, the system would have absorbed the losses, maybe with much noise in the financial press, but without causing the total freeze in the money and credit systems and collateral damage in the real economy that we seem to be experiencing. With the low levels of capital and high leverage we have had, I doubt that even perfect macro policies worldwide would have avoided some kind of crisis. Look first to the Basel capital adequacy framework when casting blame, not to the Federal Open Market Committee, China or Japan.

Paul Atkinson E-mail address: patkinson@noos.fr

Posted by: Kumiharu Shigehara | December 7th, 2008 at 9:28 pm **|** Report this comment

Martin Wolf: I think economics has become intellectually ossified, as illustrated by the comments from Paul Atkinson. It is also illustrated by the failure of the principal international organisations to foresee this crisis (with the notable, though partial, exception of the BIS) or, in my view, to analyse its causes adequately. I hope to be able to comment on these ideas, but it will take a while. Anyway, this is a really important debate. So I am sure I will return to it.

Posted by: Martin Wolf | December 8th, 2008 at 5:02 pm **|** Report this comment

Kumiharu Shigehara: I broadly agree with Martin Wolf about his remarks on the failure of the principal international organisations to foresee this crisis. In this connection, he and other members of this Forum might be interested in an article I have contributed to the Japan Times (English edition).

Kumiharu Shigehara *was chief economist and deputy secretary-general of the Organisation for Economic Co-operation and Development from 1992 to1999 and chief economist of the Bank of Japan from 1989 to 1992. He is currently chairman of the International Economic Policy Studies Association.*

Posted by: Kumiharu Shigehara | December 9th, 2008 at 3:57 pm **|** Report this comment

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In this forum, some of the world's leading economists debate issues raised in the Financial Times columns by Martin Wolf, Financial Times associate editor and chief economics commentator, Lawrence Summers, Charles W. Eliot University Professor at Harvard University, and occasional guest economics columnists. Participants include well-known commentators such as Jagdish Bhagwati, Brad Setser, Andrew Smithers, Dani Rodrik and Robert Wade; and two winners of the Nobel Prize in Economics - Edmund Phelps and Joseph Stiglitz. Recent contributions have been made by Stephen King, Alistair Milne, and Kumiharu Shigehara , among others.