NRI Dream up the future.

lakyara

2010

Kyara, which means “precious” in ancient Japanese,
is an aromatic resin regarded as the highest quality of all agarwood.
“lakyara [la-kǽla]” aims to deliver the same quality as Kyara together with
NRI’s endeavour for continuous excellence and innovation to provide
the most advanced and up-to-date information to our readers worldwide.

vol.79 (26.May.2010)

Background to Shirakawa’s instruction to staff

Nomura Research Institute, Ltd.

The persistent downward pressure on prices in Japan may be attributable in part to the inefficient allocation of economic resources. Industrial policy could be utilized as a second-best measure if there is insufficient governance by the capital markets and banks (via lending). This would also be in line with the changes in policy philosophy since the financial crisis. Although the traditional view is that central banks' role is to keep interest rates low in order to mitigate the costs of resource reallocation, it may be time for them to consider further measures. Such measures should (1) be part of government-led industrial policy, (2) incorporate a mechanism for automatic deactivation such that usage naturally declines as the need for it diminishes, and (3) coexist well with existing monetary policy.

Introduction

Market participants were watching the 30 April Policy Board meeting. Although the forecast of core CPI inflation turned out to be in line with market expectations, the meeting had one unexpected outcome: it was revealed that Governor Shirakawa had "instructed the staff to examine and report...on possible ways to support private financial institutions in terms of fund provisioning with a view to strengthening the foundations for economic growth.".

These policy measures will probably be fleshed out going forward. In this report, I would like to focus more on the issues facing the Japanese economy and the changes in policy philosophy that led to this directive as well as the role of the central bank.

Reallocation of economic resources in Japan

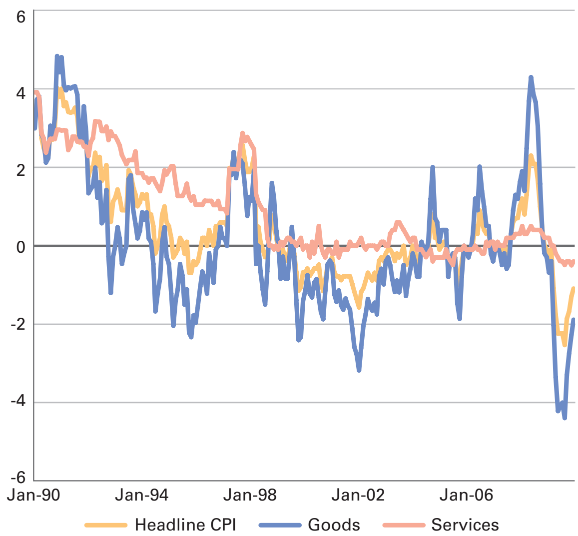
At its eighth meeting, held in February, our FMP began discussing the role of monetary policy under the persistent deflationary pressures and rising fiscal deficits in Japan.

Core CPI inflation has remained around zero or modestly negative since our previous crisis despite substantial economic growth in the interim. Unfortunately, empirical analysis has been insufficient to produce a consensus, as noted at the ninth meeting of our FMP on 12 April. Domestic economists like to cite a cyclical shortage of aggregate demand, but as prices have been soft across the business cycle it is reasonable to turn attention to structural factors.

One of the few discussions covering this period was conducted at a joint conference last November by the University of Tokyo and the BOJ ("Japanese productivity trends in the 2000s—measurement, background factors, and implications). A collection of relevant macroeconomic data with reference to the conference findings suggests the potential causes of persistent deflationary pressures:

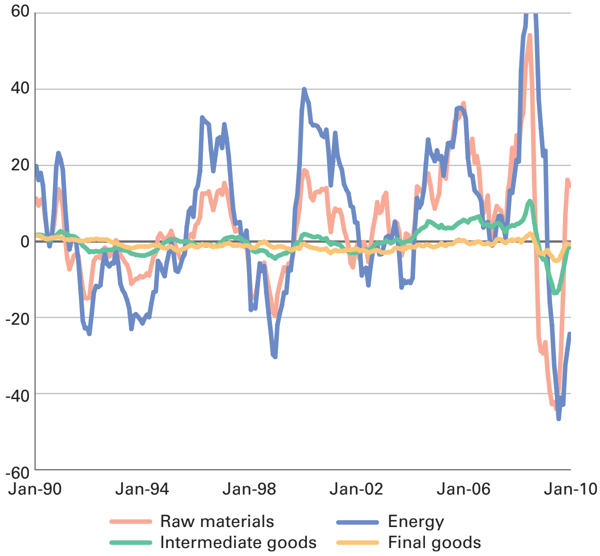
(1) Productivity had risen at the macroeconomic level. In many industries, however, the capital stock (and the bank

Exhibit 1. CPI (y-on-y %)



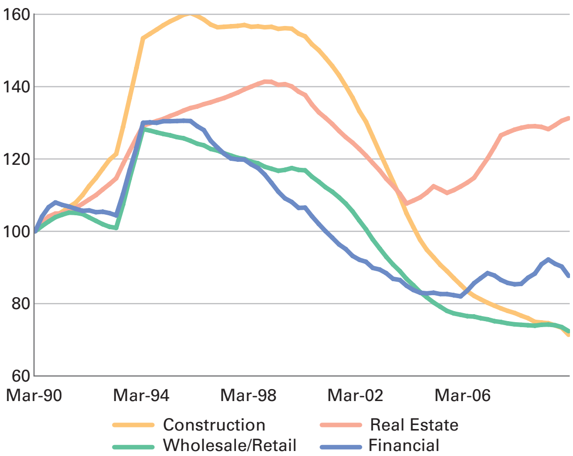
Source: MIC, BLS

Exhibit 2. Corporate Goods Price Index (Stage of demand: y-on-y %)



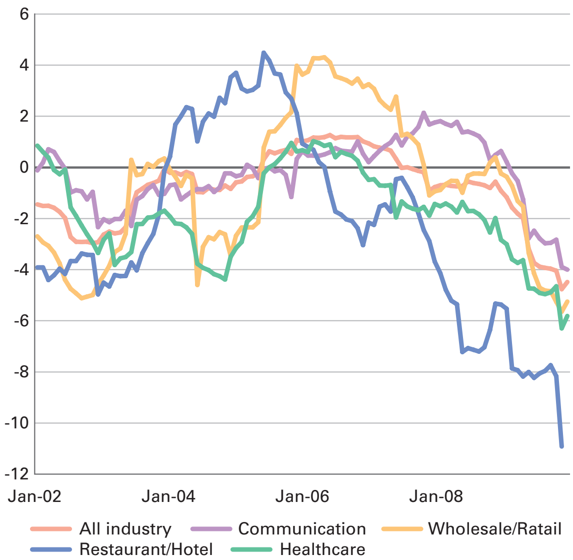
Source: BOJ

Exhibit 3. Outstanding of bank lendings (4QMA, March 1990=100)



Source: CAO, BOJ

Exhibit 4. Total wage payment (y-on-y % in terms of 12M MA)



Source: MHLW

lending underpinning it) continued to shrink, and there was no improvement in ROA or other indicators of profitability. In other words, the correction in the capital stock triggered by the previous financial crisis may have been ongoing.

(2) Employment growth exceeded capital stock growth in many industries. This has contributed to sustaining employment, but by shifting the burden of adjustments onto wages it may have resulted in downward pressure on wages.

Of course these are working hypotheses, and further empirical study is needed. I would also note that downward supply-side pressure on prices due to productivity improvements would ordinarily be offset by increased demand from higher real incomes, but Japan was unable to benefit from this effect because of worsening terms of trade.

Nevertheless, factors like the two listed above suggest that the steady deflationary pressure may have been attributable to (1) an inefficient allocation of economic resources at the macro level or (2) a long (and ongoing) correction process as the economy moved towards their efficient allocation. That suggests that a more efficient allocation of resources—or an acceleration of the reallocation process—could boost economic growth and ease downward pressure on prices. Higher rates of economic growth could also make it possible to bring Japan's chronic fiscal deficits under control sooner.

Some might argue that a more efficient allocation of resources cannot be expected to provide major quantitative benefits, regardless of any impact it might have. The answer to this question will have to wait for empirical studies covering the last years. Nevertheless, boosting the efficiency of resource allocation is one of the few options Japan has to lift economic growth. As the population ages, the savings rate plunges, and fiscal deficits continue to build up, Japan has gradually decreasing surplus capital or labor (from the perspective of I-S balance). Accepting large numbers of immigrant laborers or taking advantage of reserve currency status to attract foreign capital, like the US has done, are not realistic options in the short or medium term. In summary, the more efficient use of resources has become increasingly important as a tool to lift growth.

Changes in policy philosophy

As a way out of deflation, improvements in the aggregate supply/demand balance from higher growth, which in turn ease deflationary pressures, are preferable. This point came up in discussions during my visit to the US in March. I presented the working hypotheses noted above as reasons for downward pressure on prices and suggested the adoption of an industrial policy—ie policies using tax incentives and subsidies to promote more efficient and more strategic reallocation of economic resources.

In a market economy, the reallocation of resources is supposed to occur as the result of governance by the capital markets and banks (via their lending function). Unfortunately, both the macro data and individual news reports suggest it would be unrealistic to expect this mechanism to function properly in the current Japanese economy. I think the use of industrial policy to promote the reallocation of resources might therefore be considered as a second-best measure.

As many of the people I spoke with in the US were closely involved with the markets, I had expected strong opposition to this proposal. But not everyone dismissed it out of hand. It may be that the gist of my point was not communicated well because, unlike in Japan, there is no widely shared conception of what constitutes industrial policy. But I cannot help but feel that, even among US market participants, views of economic policy—and in particular their tolerance for policy discretion—may have changed.

This may be based partly on the objective assessment that the authorities' flexible response to the unfolding crisis helped prevent a collapse of the financial system and was effective in bringing about an recovery. I think it is also manifested in the surprisingly broad support shown for a paper published by top IMF economist Olivier Blanchard in February, in which he controversially proposed a restoration of discretionary policy (although many focused on his proposal of a 4% inflation target). The fact that the US government itself has turned to industrial policy—in the form of export promotion and measures to foster environmental technology—also suggests that policy philosophy has changed, although not everyone supports these interventions, and to some extent these are intended as a response to competition from the rest of the world.

Role of the central bank

Even if it would be meaningful to have an industrial policy, it is not clear whether that role should be played by the central bank. The traditional view has been that the central bank should focus on mitigating (with lower interest rates) the burden of the reallocation of resources—ie the costs of starting new businesses and shutting down existing ones, scrapping production facilities, and in the case of workers retraining for the sake of a new job. The measures taken by the BOJ to facilitate access to corporate finance were based on this approach, which will probably be repeated.

When visiting the US, I suggested the possibility of a policy mix consisting of government industrial policy and central bank efforts to ease the burden by keeping interest rates low. But we should dismiss out of hand a more forceful response. The Fed has effectively taken over US housing policy with its purchases of MBS, and the ECB has played a central role in addressing the crisis in Eurozone nations. It may be that efforts to stabilize the MBS market should have been left to the GSEs, or that the ECB should have proceeded quietly to normalize monetary policy. The reality, however, was that such a stance would have been unable to deal with the immediate problems, and that is why the Fed and the ECB chose to act in ways that went beyond the traditional role of a central bank. If rising fiscal deficits make it difficult for Japan to provide tax incentives when implementing industrial policy, for example, the central bank could consider acting directly in its supply of funds.

I also think the adoption of measures that go beyond traditional views could lead to the benefit of restoring the freedom of monetary policy. If the central bank were to separately adopt and administer measures designed to facilitate industrial policy, monetary policy could be freed from the need to keep interest rates low and could be reassigned to its duty of smoothing out the business cycle.

A few points of caveats

While it is worth considering expanding the central bank's role in industrial policy, there are a few points as caveats.

First, central bank measures need to be positioned as part of the government's industrial policy. While supporting an expanded role for the central bank in supplying liquidity, I think the decision of which specific industries require a strategic reallocation of resources should be left up to the government. Although the information and knowledge gleaned from the central bank's economic analysis can be useful in planning industrial policy and should be utilized to the greatest extent possible, decisions regarding the allocation of resources should be made by the government.

On this point we need to remember the "unconventional policy" implemented by central banks during the current crisis. While these policies were effective, their side effect was that central banks in effect altered the allocation of resources in the economy (see FMP Perspectives: Assessing Unconventional Monetary Policy, published in August 2009). Accordingly, any new measures should be positioned as part of governments' growth strategies..

Second, it is essential that these measures incorporate an automatic "deactivation" mechanism. The optimal solution is to promote the reallocation of resources using governance by the capital markets and banks (via lending). Inasmuch as industrial policy would be second-best, the main role should be transferred to market mechanisms as soon as market mechanism is restored. Moreover, once the need for support diminishes, it may be preferable to discontinue these measures while maintaining its industrial policies. The various types of unconventional policy reaffirmed the need for a deactivation mechanism that causes demand for the measures to decline naturally as the markets stabilize. The measures should also incorporate such a mechanism—examples might include the use of auctions or restrictions on the range of eligible collateral or the duration of loans.

Third, it is important to achieve a coexistence of traditional monetary policy and industrial policy measures. In terms of the business cycle, if emerging economies continue to expand and commodity prices remain at elevated levels, a zero-interest-rate policy will result in very accommodative monetary conditions. There may well come a time between now and the end of the forecast period in the BOJ's Outlook when a policy rate hike should be considered. At that point, it will be critical for the sake of economic stability that the continuation of policy measures to facilitate industrial policy does not act as a constraint on monetary policy. Achieving a balance between the two will not be so simple, but I do not think it is impossible. Possible solutions include: (1) using the CLF and paying interest on current accounts, thereby making it possible to treat interest rates and the quantity of money as separate policy variables; (2) maintaining the stability of medium- and long-term interest rates even after the policy rate is raised; and (3) finding ways to prevent funds supplied via policy measures from being used for purposes other than those for which they were intended (such as investments in market assets).

Conclusion

The policy measures that Mr. Shirakawa has asked BOJ staff to study should not be dismissed out of hand as marking an unwelcome departure from the central bank's traditional role. Instead, I think we should view such measures as part of the government's growth strategy, pay close attention to the discussion surrounding them, and do what we can to ensure that the debate remains constructive.

Author's Profile

Tetsuya Inoue

Chief Researcher
Center for Financial Markets and Technology Research

E-mail : kyara@nri.co.jp

Inquiries to : Center for Financial Markets and Technology Research
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.co.jp/english/opinion/lakyara