



Inflation, expectation, and the real economy in Japan[☆]



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ABSTRACT

This paper investigates the effectiveness of unconventional monetary policy in Japan by taking into account people's price expectations. First, a stability test revealed that the effects of the 2011 earthquake were not strong enough to have caused a structural break in the economy. Second, the impulse response analysis reveals that an expansionary policy has a temporary, positive effect on financial and real economic variables. However, the inflation rate does not increase to a statistically significant level from zero. Third, market participants' expectation of a devaluation of the yen occurs in advance of an actual increase in the monetary base.

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1. Introduction

In January 2013, jointly with the Abe administration, the Bank of Japan adopted a “bold monetary policy,” under which the Bank set the “price stability target” at 2% inflation in terms of the year-over-year rate of change in the consumer price index.¹ In April 2013, when Governor Kuroda took office, the Bank of Japan launched Quantitative and Qualitative Monetary Easing (QQME), which aims to achieve 2% inflation by doubling the monetary base in two years. That is to say, the Bank of Japan employs an inflation targeting policy to eliminate deflationary expectation, which has grown in Japan over the last two decades.

Using Japanese monthly data from 1995 to 2010, Schenkelberg and Watzka (2013) report that the quantitative easing policy induced a temporary increase in the real economy and inflation.² Fig. 1 depicts the year-over-year monthly rates of change in the monetary base and core Consumer Price Index (CPIcore). They

appear to closely follow each other since around 2010. However, some researchers cast doubt on the effectiveness of the QQME. For example, Ikeo (2013) and Ito (2014) do not believe that the Bank of Japan can control people's price expectations. Also, the International Monetary Fund (IMF) (2014) projects a continuing risk of economic stagnation if the government cannot implement substantial fiscal consolidation. Fig. 2 illustrates the year-over-year monthly rates of changes in the yen per U.S. dollar rate and an index for all industrial activities. Depreciation of the yen began in fall 2012 before Mr. Abe came to power.³ The activity index appears to have increased afterward.

Since 1999, the Bank of Japan has adopted a series of unconventional monetary policies: a zero interest rate policy (1999/2–2000/8), quantitative easing (2001/3–2006/3), comprehensive monetary easing (2010/10–2013/4), and QQME (2013/4~).⁴ Krugman et al., (2015) define unconventional monetary policies as the measures by which “the central bank buys specific categories of assets with newly issued money, greatly increasing the money supply in the process” (p. 516). Ueda (2013a, 2013b) reports that many policy decisions made from December 2008 to April 2013 have had a far-reaching effect on financial variables such as share prices or exchange rates. In addition to stock prices,

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¹ See Cabinet Office (2013).

² Ijiri (2016) uses monthly data from 1998 to 2008, similar to Schenkelberg and Watzka's (2013). He reports that the unconventional monetary policy had a substantial effect on real economic indicators until late 2002.

³ Fukuda (2015) reports that foreign investors responded more aggressively to Mr. Abe's policy regime (e.g., so-called “Abenomics”) than domestic investors did before May 2013. In other words, foreign investors' trade contributed to the depreciation of the yen at the beginning of Abenomics. Kano and Morita (2015) also analyze the depreciation of the yen against the U.S. dollar under Abenomics.

⁴ See Kuroda (2014).

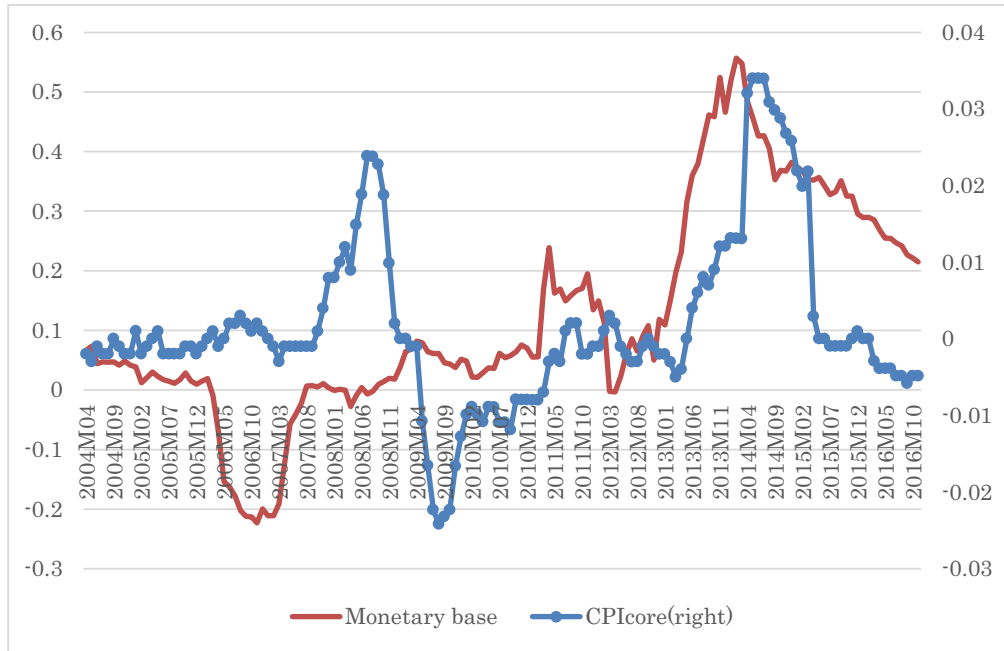


Fig. 1. Inflation and monetary base. Sources: Bank of Japan and Statistics Bureau.

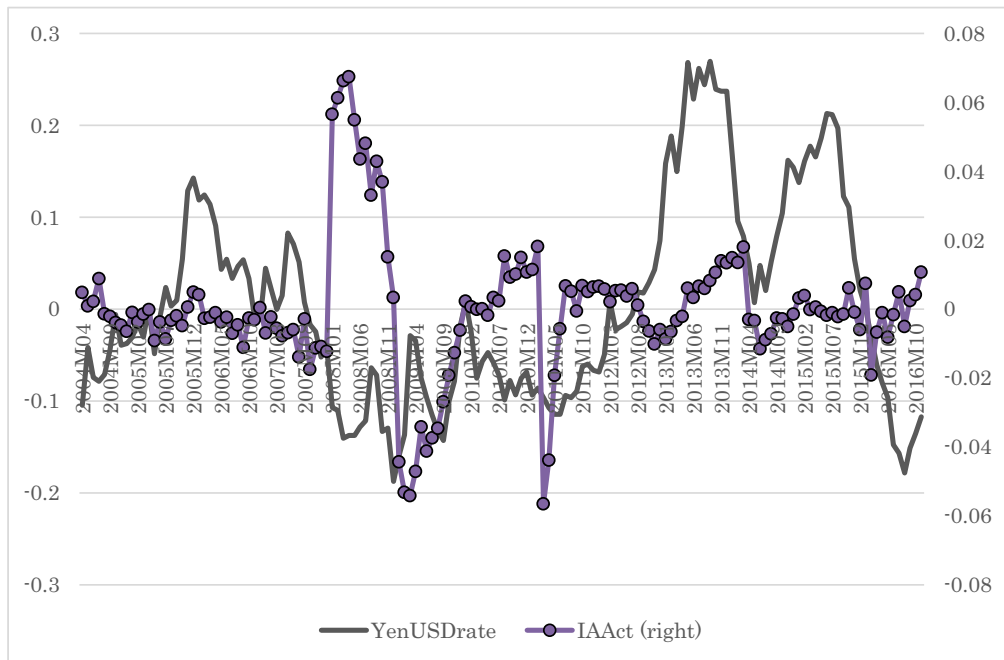


Fig. 2. Exchange rate and index for all industrial activities. Sources: Bank of Japan and Ministry of Economy, Trade and Industry.

Honda (2014) presents evidence that the unconventional monetary policy increased production during the period from March 2001 to March 2006. In Shioji et al., (2012), however, Iwamoto argues that the effectiveness of unconventional monetary policies emerges from arbitrage opportunities, which rarely exist in modern financial markets. Also, the Bank for International Settlements (BIS) (2012) contends that the extraordinary monetary accommodation masks private and public sector balance sheet problems and eventually delays the long-term recovery. Table 1 provides a list of previous studies that reached different conclusions about Japanese monetary policy. In sum, researchers have not established a consensus about the effectiveness of unconventional monetary

policies. In particular, we know little about their efficacy since 2014, when Governor Kuroda took office at the Bank of Japan.

The purpose of this paper is to assess the influence of the unconventional monetary policy by taking into account people's price expectations in monthly data.⁵ The use of monthly data accords with the QQME policy scheme using the year-over-year rate

⁵ Ueda (2010), and Dekle and Hamada (2015) include an expected inflation rate in their quarterly data. However, their sample periods start from the 1970s, in which the Japanese monetary policy was *conventional*. With an expected inflation rate, this paper focuses on the period during which the monetary policy has been *unconventional*.

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