

What does the Bank of Japan do to East Asia? [☆]

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Abstract

In recent policy debates some have argued that expansionary monetary policy in Japan can increase real output in Japan and in Japan's neighbors, while others have warned that it is a beggar-thy-neighbor policy. In this paper we estimate structural vector autoregressions to assess the effects of Japanese monetary policy shocks. We find that the effects of Japanese monetary policy shocks on macroeconomic variation in East Asia have been modest and difficult to reconcile with the beggar-thy-neighbor view. We estimate that the Asian crisis was preceded by expansionary monetary policy shocks in Japan, but we fail to find support for the view that these shocks contributed to the crisis.

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1. Introduction

This paper is motivated by an ongoing debate about the effects of Japan's monetary policy on Japan and on Japan's neighbors. Economists on one side of the debate argue that expansionary monetary policy in Japan can cause an increase in real output in Japan and positive spillover effects on real output

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of Japan's neighbors.¹ Economists on the other side of the debate argue that expansionary monetary policy in Japan is a beggar-thy-neighbor policy.² To give a specific example, a common view is that "loose" Japanese monetary policy aggravated the Asian crisis of 1997.³

Each side of the debate invokes theoretical open-economy models to support its claims. Monetary open-economy models predict that an expansionary monetary policy shock causes depreciation of the domestic currency. In addition, models with nominal rigidity predict that an expansionary monetary policy shock causes an increase in domestic real output in the short run. As regards effects of domestic monetary policy shocks on foreign real output, models with nominal rigidity make conflicting predictions. On the one hand, an increase in domestic real output tends to raise the demand for imports, causing a positive spillover effect on real output abroad. On the other hand, expansionary monetary policy causes real depreciation and thus diverts demand to domestic away from foreign goods — this is the beggar-thy-neighbor effect.⁴ McKinnon and Schnabl (2002, 2003) argue that the beggar-thy-neighbor effect prevails in East Asia and that the effect can destabilize the region, which will have adverse consequences for Japan itself. Policymakers seem to share this point of view (see e.g. Fischer (2001) and Okina (1999)). Yet which of the effects prevails is ultimately an empirical question.

This paper makes an empirical contribution to the debate. We use structural vector autoregressions (SVARs) to estimate the effects of Japanese monetary policy shocks on Japan and on Japan's neighbors. With SVARs we can estimate the effects of monetary policy shocks with much weaker a priori restrictions than are required in calibrated or estimated equilibrium models. To identify Japanese monetary policy shocks, we use four identification schemes. We believe that robust conclusions are best achieved by examining results from more than a single identification scheme. Like both sides of the debate, in assessing the cross-border transmission mechanism for Japanese monetary policy shocks we pay special attention to the external value of the yen and to international trade.

Both sides of the debate presume that the effects of Japanese monetary policy shocks can be large. We estimate the size of these effects. We find that domestic monetary policy shocks most likely explain at most 10% of the variation in Japan's real GDP and Japan's trade balance and at most 20% of the variation in the value of the yen with respect to the U.S. dollar in the last 40 years. 10% and 20% are nonnegligible numbers, but they are modest. We find that the contribution of Japanese monetary policy shocks to the variation in real GDP and trade balances of Japan's neighbors is even more modest, most likely about 5%. Thus Japanese monetary policy shocks have historically played only a modest role as a source of fluctuations in East Asia, contrary to what both sides of the debate presume.

We find that expansionary Japanese monetary policy shocks increase real output in Japan and depreciate the yen vis-à-vis the U.S. dollar, as presumed by both sides of the debate, though these effects are uncertain and do not emerge clearly under all identification schemes.

The sides of the debate differ with respect to the sign of the international spillover effects of Japanese monetary policy shocks. We evaluate the sign of these effects. We find that an expansionary shock in monetary policy causes a decrease in net exports in Japan. Furthermore, net exports of Japan's neighbors increase in the short-run. These results suggest that Japanese monetary policy shocks do *not*

¹ See e.g. Bernanke (2000), Krugman (1998), McCallum (2000), Meltzer (2002), Orphanides and Wieland (2000), Svensson (2001, 2003).

² See e.g. McKinnon and Schnabl (2002, 2003).

³ See Corsetti et al. (1999) for a discussion.

⁴ See Corsetti et al. (2000) for a model of international spillover effects of monetary policy shocks.

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