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Policy regime change against chronic deflation? Policy option under a *long-term liquidity trap* [☆]



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ABSTRACT

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The policy package known as *Abenomics* appears to have influenced the Japanese economy drastically, in particular, in the financial markets. In this paper, focusing on the aggressive monetary easing of *Abenomics*, the *first arrow*, we evaluate its role in guiding public perceptions on monetary policy stance through the *management of expectations*. In order to end chronic deflation, such as that which Japan has been suffering over the last two decades, policy *regime change* must be perceived by economic agents. Analysis using the QUICK survey system (QSS) monthly survey data shows that monetary policy reaction to inflation rates has been in a declining trend since the mid 2000s, implying intensified *forward guidance* well before *Abenomics*. However, Japan seems to have moved closer

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to a *long-term liquidity trap*, where even long-term bond yields are constrained by the zero lower bound. Consequently, no sizable difference in perceptions has been found before and after the introduction of *Abenomics*. Estimated changes in perceptions are not *abrupt* enough to satisfy “Sargent’s (1982) criteria for regime change” termed by Eggertsson (2008). This poses a serious challenge to central banks: what is an effective policy option left under the long-term liquidity trap? *J. Japanese Int. Economies* 37 (2015) 59–81. RIETI, Japan; Keio University, Japan; Australian National University, Australia; Yokohama City University, Japan; Waseda University, Japan.

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1. Introduction

Over the last two decades, Japan has suffered chronic deflation. Some compare this situation to the prolonged deflation of the *Great Depression* in the 1920s and 1930s, or, conversely, to the *Great Inflation* in the 1970s. To date, as shown by Sargent (1982), Temin and Wigmore (1990), and Eggertsson (2008), one conventional wisdom in academic literature to tackle chronic inflation or deflation is to induce *policy regime change* through the *management of expectation a la Eggertsson and Woodford (2003)*. In this paper, we examine whether the Bank of Japan, in particular, from the end of 2012, induced such a policy regime change.

After returning to the position of the Governor of Liberal Democratic Party in September 2012 and Prime Minister in December 2012, Mr. Abe introduced the package of policies known as *Abenomics*, consisting of *three arrows*: aggressive monetary easing; flexible fiscal spending; and a growth strategy. This policy package appeared to have drastically influenced macroeconomic and, in particular, financial variables to date. The exchange rate depreciated considerably from 82 yen to the dollar at the end of November 2012 to 97 yen to the dollar at the end of April 2013. The stock price of the Nikkei 225 increased massively from 9446 yen at the end of November 2012 to 13,860 yen at the end of April 2013.

Many argue that, among the three, the first arrow should have played a significant role in these developments, albeit casually. During this period, the target level of inflation was raised from 1% to 2% in January 22, 2013. Also, Mr. Kuroda, newly appointed Governor of the Bank of Japan in March, also introduced the *Quantitative and Qualitative Monetary Easing (QQME)* policy on April 4, 2013, by stating “[i]t will double the monetary base and the amounts outstanding of Japanese government bonds (JGBs) as well as exchange-traded funds (ETFs) in two years, and more than double the average remaining maturity of JGB purchases.”¹

Even though the QQME is massive and outstanding in terms of the increase in amount of the base money, it is well-known that quantitative easing and therefore the QQME *per se* do not have a large impact on the macroeconomy. Eggertsson and Woodford (2003) propose the “irrelevance proposition for open-market operations” under the zero lower bound. This is because, in the standard new Keynesian model, (the quantity of) money is irrelevant to equilibrium determination.² Such a policy

¹ Newly-introduced policy tools include (1) the adoption of the “monetary base control”; (2) an increase in JGB purchases and their maturity extension; (3) an increase in ETF and J-REIT purchases; and (4) the continuation of the QQME.

² A notable exception is nonseparability between the consumption and real balance in utility as analyzed in Koenig (1990). Fujiwara (2007) shows the degree of nonseparability is small.

Furthermore, the “portfolio balance” effect coined by Tobin (1958), as studied in Orphanides and Wieland (2000) in the context of foreign exchange rates and Gagnon et al. (2011) and Joyce et al. (2011) in terms of long-term bond yields, may work. Empirical investigation of the portfolio balancing channel is, however, difficult, as it involves expected covariances among returns in financial variables.

Note also that as Cochrane (2011) argues, helicopter money, namely printing money and giving it to economic agents directly, is “at heart a fiscal operation. It is a transfer payment.” There, a “central bank may be almost powerless to avoid deflation or inflation.”

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