

Function Summary

Japan: Policies to End the Recession *Professor Warwick McKibbin*

Warwick began by noting that Japanese economic performance since 1990 had been characterised by low levels of growth and a collapse in total factor productivity; a massive deterioration in their fiscal position; and, for most of the period, Yen appreciation. He argued that the underlying cause of this poor performance was not a credit crunch: while it was true that bank lending had collapsed, this had to a large extent been offset by an increase in internal sources of corporate financing. Rather, a sequence of very poor fiscal and monetary policy decisions and the imbalances these had created were the primary cause.

Warwick then applied his inter-temporal general equilibrium model to consider the impact on growth, relative to baseline, of a number of fiscal and monetary policy options. Some of the main options and their impact were seen to be as follows:

- increased monetisation by the BOJ, for example by way of increased JGB purchases, had a positive but temporary impact on growth primarily through the mechanism of reduced real interest rates and a temporary real depreciation of the Yen;
- a permanent increase in government spending, financed by way of increased bond issuance, had a small but temporary positive impact on growth which was more than offset by negative impacts beyond year 1. The negative impact beyond the first year reflected household and corporate perceptions of higher future tax burdens, crowding out via higher bond yields, and an appreciation of the Yen;
- announcement of a credible 3% inflation target had a longer lasting and significant, but still temporary, effect on growth, primarily through the channel of yen depreciation. However, it was not clear how such an announced inflation target could be made credible;
- cuts in government spending had a temporary (3 to 4 year) negative impact on growth but this was more than offset by significant longer term positive contributions, which occurred through the mechanisms of crowding in (lower interest rates) and Yen depreciation. This Yen depreciation, moreover, was not on balance a negative for the rest of Asia, as its impact was more than offset by higher Japanese imports.

In his summary comments, Warwick expressed the view that further monetary expansion in conjunction with fiscal consolidation and structural reform was required in Japan, and also suggested that temporary abolition of the consumption tax, designed to bring private consumption spending forward in time, would be helpful. Japan's problems were not insurmountable.

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