
Introduction: Financial Similarities and Monetary Differences

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Japanese macroeconomic and financial policy in the past decade has failed to respond adequately to the largest financial crisis to occur in an industrial democracy in the past 60 years. The role of this inadequate policy response in deepening and lengthening Japan's stagnation since 1992—the costliest recession suffered by any advanced economy in the postwar period—has brought a wide consensus of frustration among economists internationally. Contrary to the popular picture of economists continually disagreeing with one another on macroeconomic issues, the analysis of financial crises (at least of those occurring in the industrial world) is an area where much agreement exists. Economists agree that such crises are the source of most of the costliest recorded interruptions in countries' economic growth, that they usually follow situations of partial deregulation and of asset price bubbles, that they require some combination of bank closures and public capital infusion to resolve, and that they both constrain and respond to monetary policy decisions.

None of this is to say that Japanese economic officials made unique mistakes—part of the reason for the consensus on just how bad financial crises are is that we have had so much experience with them. As Yoshinori Shimizu notes in his essay in this volume¹: “The period 1980-96 witnessed widespread financial deregulation for many of the world's economies. As a result of this increasingly competitive environment, 133 out of 181

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1. In this introductory chapter, any quotations unaccompanied by a specific bibliographic citation are taken from the named author's contribution to this volume.

IMF member countries experienced significant banking-sector problems, which were often the worst seen since the Great Depression of the 1930s." This list of financial crisis victims besides Japan in just the past 15 years includes such other major economies as France, Sweden, the United Kingdom, and the United States.

As Benjamin Friedman reminds us in his essay: "A decade ago, it was US banks, and even more so the US savings and loan (S&L) industry, that were in crisis. These institutions too suffered major loan losses, experienced failure rates unprecedented since the depression of the 1930s (especially among S&Ls, but among banks as well), and saw the market capitalization of survivors fall to a small fraction of its precrisis level. Resolution of the crisis took significant government intervention, both in the provision of public funds to pay off the depositors of institutions that failed outright and in managing the process of consolidation among those that did not (at least not formally)."

There is even some fear that the shoe may be getting ready for a return to the US foot, given the huge run-up in US equity prices in the second half of the 1990s. In the words of Olivier Blanchard in his essay below, "How monetary policy should react to bubbles is clearly of more than historical interest. We now have one and a half experiments, the Japanese one, and the US one on the way up. What remains to be played out is the US one on the way down. It is an understatement that this may not be a bad time to assess the lessons from the Japanese full experiment."

This costly recurrence of financial crisis, despite hard-won knowledge, illustrates Alan Blinder's "Murphy's Law of economic policy": "Economists have the least influence on policy where they know the most and are most agreed; they have the most influence on policy where they know the least and disagree most vehemently."² In such a situation, it is all the more incumbent upon policy economists to understand the apparently overwhelming incentives for policymakers to act oppositely from the recommended course, and to redouble their efforts to communicate their recommendations in a form that will have influence. Rather than throwing up their hands in frustration as the incidents multiply, they need to show carefully and objectively that the mainstream analysis applies in the latest case as well, with the politically or ideologically driven policy missteps—and their economic costs—clearly delineated.

That is the uncynical intention and, we hope, useful purpose of this volume: to analyze the causes and impact of the Japanese financial crisis of the past 10 years; to put that crisis into perspective through comparison with the US financial crisis of the mid-1980s to the early 1990s; to assess the prospects for Japan's recovery from its current straits, and the financial and monetary policy steps necessary to bring about that recovery; to

2. Quoted in Paul Krugman, "Reckonings: A Rent Affair," *New York Times*, 7 June 2000, 31.

consider what lessons might be drawn to prevent and, failing that, resolve such financial crises in the future; and, finally, to identify for urgent consideration those remaining open policy issues of disagreement among economists raised by the experience of Japan in the past decade. The hope is both to have an influence on Japanese economic policy today, while so much remains to be done there, and also to reduce the likelihood and costliness of future financial crises elsewhere. Murphy's Law should not be taken for granted when so much is at stake.

In this pursuit, we have brought together leading Japanese and US economists, some with experience at the most senior policymaking levels, to discuss the Japanese financial crisis of the past decade. Although the degree of consensus among the contributing authors should not be exaggerated—for example, the desirability of central banks targeting asset prices to prevent bubbles (and perhaps thereby preempt crises) splits those writing here, pro and con—there is substantial agreement among the assembled analyses. On the financial side, there emerges a sense of extreme similarities between the Japanese banking crisis of the 1990s, and the US S&L crisis of the 1980s, both in source (mismanaged partial deregulation combined with too much regulatory forbearance) and in required means of resolution (injection of public funds, losses to shareholders, and liquidation of bad assets).

On the monetary side, there is a common belief that the Bank of Japan (BOJ) has diverged from the norms of central banking best practice, increasingly so since the Japanese economy fell back into recession in 1997, with a passive-aggressive acceptance of deflation. Although there are some differences over tactics, the authors here from both sides of the Pacific agree that a still recovering Japan requires a much smaller, more competitive, banking sector, along with a much more expansionary monetary policy, and that both are feasible goals. All these recommendations rest on more general lessons drawn about the nature of financial crises and the possibilities for monetary policy that make up the bulk of this volume.

The need for continued efforts in the financial and monetary arenas does not indicate that Japan remains in as precarious a position as it was in when its financial crisis was at its peak in 1997-98. At that time, especially between November 1997, when Yamaichi Securities and Hokkaido Toku-shoku Bank were closed, and October 1998, when the bank recapitalization legislation passed the Diet, Japan teetered on the brink of outright financial collapse.³ Japanese savers were holding their money increasingly in cash or in postal savings accounts, and withdrawing funds from the private banking system; foreign banks were increasingly reluctant to engage in even overnight lending to Japanese banks, threatening basic liquidity in the payments system; cascading declines in land prices, stock

3. Posen (1998, chap. 4) gives an overview of the situation as of July 1998 before the reforms.

prices, and the yen were eroding banks' capital, inducing a spiral of debt deflation. The Bank of Japan was resorting to extreme purchases of corporate debt (at times, 50 percent of the commercial paper issued) just to keep the payments system going.

From September 1998 on, in a series of reversals of established Japanese government practices, fiscal policy became meaningfully expansionary, financial supervision was tightened, a pair of major failed banks were nationalized, and dispersion in performance among Japanese corporations (including the number of bankruptcies) was allowed to increase. A return to weakly positive economic growth has resulted, with continued expansion forecast for 2000-02; this has confounded many skeptics (including some Japanese government officials), who were convinced that Japan was on a trend toward permanent decline. At least as important, there has been some reintermediation in the Japanese banking system, with the "Japan premium" disappearing for the remaining number of banks active in international interbank markets, and the ratio of currency to deposits declining.

This partial and pragmatic program has put a floor under Japan's economic outlook, barring overt reversals in the stance of policy or in the enforcement of what financial reform has already been mandated. But the trend of Japanese economic growth remains well below potential output, with a cumulative output gap in excess of 12 percent of GDP, and financial reconstruction, let alone broader structural reform, remains far from complete. So the end of panic should not be a cause for satisfaction. The absence of an overt crisis does, however, provide the opportunity for reflection on how close Japan came to the brink, and what we can learn from this experience.

Financial Similarities

Despite the vast problems that remain, no area of Japanese economic life has undergone as radical a change as that of the financial system in the past 15 years. It is the mismanagement of this transformation that gave rise to financial fragility throughout the Japanese banking sector, and it is the delay in completing the transformation that has increased the cost of the financial crisis severalfold. The "Main Bank" system in Japan of cross-shareholdings and heavy corporate dependence upon bank loans for finance has been much studied and, although occasionally exaggerated in description, formed one of the central components of the Japanese economic framework before 1986.

The Ministry of Finance's postwar "convoy system" approach to bank supervision—allowing no banks to fail, having the large banks not only assist each other in time of need but rise and fall together, and keeping up heavy barriers to entry into corporate finance—reinforced the long-

term lending relationships between the banks and corporations. Complementing the lending side of the banking system lay the savings side, where Japanese households kept the majority of their assets in low-yielding bank accounts that were perceived as riskless and that provided a pool of cheaply available, loanable funds. All the risk-averse constituents of Japanese economic life (e.g., bank managers, government bank supervisors, small savers, company salarymen from firms in *keiretsu* relationships) believed themselves to have an interest in the system.

Yet for all its embeddedness in a distinctive web of functional relationships, the breakdown of the Japanese Main Bank system, and the ensuing financial crisis, followed a sequence familiar to observers not only of the US S&L troubles but also of the French Crédit Lyonnais bailout, the Swedish banking crisis, and the UK property bubble, as well as others. This sequence fits very well with standard economic models of banks' and regulators' incentives, given modern theories of the imperfect information under which they both work. Without the existence of imperfect (i.e., costly to acquire and impossible to perfectly verify) information about corporate investment projects, there is no reason for banks to exist—all financing could be done in arm's-length securities transactions. Without the existence of imperfect information about bank balance sheets, there is no reason for deposit insurance or for regulatory supervision of deposit-taking institutions to prevent bank runs and payment system difficulties.

The standard path to financial crisis begins, unsurprisingly, with banks having grown in size, number, and complacency due to their initially protected status. As financial technology improves and deregulation starts, banking finds itself in a long-term sectoral decline as an industry, being squeezed by more efficient ways for corporations to raise funds and by demands for higher interest rates from savers who, at the margin, look for alternative investments. To make up for their declining margins on and quantity of loans to low-risk large corporations, banks begin lending to lower-quality borrowers and have to rely more heavily on collateral, including real estate. Partial deregulation limits the choices of new businesses into which banks can go, but a continued deposit insurance safety net encourages risk-taking behavior with readily available funds.

Given the years of protection from market discipline, most bank balance sheets remain beset by lax accounting practices and undercapitalization, even as the riskiness of their loan portfolios increases. When the rate of economic growth slows, and the prices of land and other assets decline, the banks suffer loan losses, and are forced to make these up by calling in other loans and (when enough losses accumulate) out of their capital. The contractionary process is frequently, though not inevitably, touched off by the collapse of an asset price bubble. When there has been a bubble,

generally the volume of loans on banks' books, and the proportion of those loans likely to fail, is all the higher.

This begins a cycle of credit contraction and bank balance sheet erosion, and once this cycle starts, the size of the bad loan problem is likely to expand for some time. Any banks that for these reasons fall below the regulated capital standards, or worse below zero equity, have the incentive to "gamble on resurrection," that is, to roll over nonperforming loans or make additional risky loans in hopes of getting high enough returns to come back to solvency, because they have nothing more to lose. Because the majority of loans are backed by land as collateral, the accumulation of nonperforming loans also has a feedback effect on the quality of other borrowers' collateral through causing declines in real estate prices.

In combination with the usual effect on business failures of a recession, this decline in the value of borrowers' collateral increases the total number of nonperforming loans, further eroding banks' portfolios. It also increases the adverse selection of borrowers by banks, shifting their portfolios toward a worse balance of risk-return overall: Banks cut back new lending to low-risk, low-return projects because of the absence of potentially capital-rebuilding large gains there, but they continue to extend or roll over credit to outstanding questionable borrowers to put off, if not avoid, writing down the value of the loan losses.⁴ Although banks hope that by waiting for greater economic growth they will see some of their nonperforming loans return to profitability, the banks actually work against macroeconomic recovery with their inefficient lending behavior, their accumulation of nonperforming loans, and their contribution to uncertainty in asset—particularly real estate—markets.

This is exactly what happened in Japan after deregulation. According to Ryoichi Mikitani in his essay below, "Toward the end of the 1970s, the Japanese economy caught up with the Western industrial countries. It was time to alter the economic regime from the old to the new one: from indicative industrial policy administered by the government to the guidance of the free market; from a bank-securities sector heavily regulated by the Ministry of Finance to a less regulated, more competitive, globally standardized financial sector; from Japanese corporatism to transparent management of corporations. . . . However, neither the financial institutions nor the big corporations were willing to take off their protective heavy coat and to work with their sleeves rolled up." Instead, Japanese banks repeated their old lending practices with their new customers, and they refused to shrink the industry even as demand for their services declined, given the vast body of deposits left in their hands by Japanese

4. Although some observers have made a major point of the distinctiveness of the Japanese Main Bank system in its having banks work out temporary liquidity problems for borrowers in relationships with the bank, the phenomenon of banks rolling over credits when under duress to avoid taking write-downs of bad loans is universal.

savers. Although it took time for the effects of increased competition to be felt, it was inevitable.

Shimizu demonstrates in his essay that increasing financial competition in Japan led to declining loan portfolio quality through exactly the channels predicted by the standard scenario. “The higher the initial share of large firms in [banks’] loan portfolios, the larger the shift of their lending patterns. The long-term-credit banks were forced to make the most drastic adjustments, given continued regulatory restrictions against banks entering the security business. . . they clearly recognized the lower creditworthiness of these [newer, smaller] customers. In order to reduce their credit risks, banks made loans secured by real estate.” This shift was seen in the United States following deregulation as well, and in both countries led to persistent biases in lending—Friedman notes that “in both Japan and the United States, lending on real estate rose sharply as a share of banks’ credit creation in the years preceding the crisis—and, interestingly, continued to rise as the crisis unfolded. . . . The share of bank credit *indirectly* resting on real estate collateral was far greater.”

When interest rates rose in Japan, the bubble burst, and growth slowed in 1990-92, the cycle of increasing financial fragility kicked in. Shimizu shows that “in the 1990s, risks in the Japanese economy markedly increased, and the banks’ large share of the corporate loan market turned into a disadvantage. As stronger corporate borrowers turned to the bond market, banks were forced to make loans to less credible borrowers, and collateral was again an important criterion for loan approval. Naturally the drastic fall in land prices had an extremely serious effect on the stability of the financial system.”

Land prices have fallen essentially continuously in Japan since that time, to one-third their peak value, and banks have been reluctant to liquidate the land collateral underlying the accumulating bad loans. There is evidence (some offered by Shimizu) that Japanese banks reduced their total lending as a result, prompting a credit crunch that exacerbated the recession.

What about the role of financial policy? In the standard financial crisis scenario, as noted, the grounds for crisis are laid with protection of the banking system from competition (e.g., Japan’s convoy regulations), followed by partial gradual deregulation. Turning to policy response, banking supervisors allow a credit boom for lower-quality borrowers to occur in hopes of restoring bank profitability when the large, good borrowers go directly to capital markets. Of course, this just adds to the potential trouble on bank balance sheets when things go south. Regulators observe the bad loans, but keep quiet due to the banks’ implicit or explicit offers of direct benefits and future employment, as well as bureaucratic disincentives to delivering bad news, and simple lack of experience with accurately evaluating risky loan portfolios.

When the bust comes, supervisors engage in forbearance, meaning that they allow banks time to carry nonperforming loans rather than demanding write-downs. This forbearance arises from the hope that a return to economic growth will come, and on its own will resolve many bad loan problems, without forcing the supervisors to blow the whistle. Having regulators from multiple competing agencies⁵ adds to the incentive for forbearance, because there is the additional motivation of hoping the bad news happens on somebody else's watch, or at least that one's own agency should not be the first to admit to allowing problems to have accumulated. The interaction of moral hazard on the part of banks and regulatory forbearance on the part of supervisors is what causes the spiraling accumulation of bad loans.

This was the story in the United States in the 1980s. Friedman reminds us that "both the US government in general and the specific authorities responsible for dealing with the banking and S&L crisis acted, in some key respects, in ways that worsened the situation, and increased its ultimate cost to the economy and to the public treasury. The lessons to be drawn from that experience stem in part from observing what to do but also from what not to do." And despite this cautionary example, this was also the story in Japan in the 1990s. Bank regulators issued a litany of announcements meant to be reassuring about the extent of the bad loan problem and the adequacy of Japanese banks' capital, each of which was correctly disbelieved by other financial firms, foreign banks, and by Japanese savers as understating the problem. Each Pollyannish announcement by regulators, however, also meant another period of forbearance, during which not only were bad loans kept on the Japanese banks' books, but more bad loans and distressed real estate collateral were allowed to accumulate.

Nevertheless, the Japanese financial situation in the 1990s had at least five unique aspects. First is the issue of sheer size. The length of time during which the banks were allowed to remain undercapitalized and to accumulate bad loans, and the extent of the bad loans accumulated, were unprecedented for an industrial country. Conservative estimates put the total bad loans requiring write-downs at 9-10 percent of GDP; the high reasonable estimates are at 15 percent. For comparison, the United States S&L crisis cost the US taxpayer on the order of 3 percent of GDP. Second, the macroeconomic effects on the rest of the Japanese economy caused

5. In Japan, though all supervisors were under the Ministry of Finance, some were based out of the Bank of Japan, whereas others were part of the ministry's financial supervision arm proper, and there was bureaucratic competition. In the United States, the multitude of competing regulators—e.g., the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, and various state agencies—contributed greatly to the problems of acknowledging and then responding to the S&L crisis and the ensuing banking problems.

by any given amount of bad loans were much greater than in most other countries that belong to the Organization for Economic Cooperation and Development (OECD). This higher impact was due to the higher relative dependence of Japanese businesses on bank lending than on alternative corporate finance sources, to the widespread use of land at inflated prices as loan collateral because of the enormous bubble that preceded the crisis, and to the holdings of nonfinancial corporate shares by banks as part of their capital (putting an additional negative feedback loop on lending). The more heavily securitized US financial system, without nonfinancial shareholdings by banks, had much smaller feedback effects from bank problems on growth.

The third difference between the Japanese and US financial crises, given the opacity of Japanese accounting and property markets, was the lack of dependable information on banks' foreclosed collateral. This impeded the identification and selling off of distressed assets, a critical step in any financial cleanup. As Robert Glauber notes in his essay, US accounting was hardly stellar itself in many of the S&Ls and their borrowers, but the US real estate market was far more liquid than Japan's. Fourth, the vestiges of belief in the convoy system, and the ability of Japanese savers to switch into government-guaranteed postal savings rather than demand change, further diminished official willingness to confront the issue. In contrast, in the United States, the winds of elected officials and even popular opinion in the 1980s were blowing in the direction of greater deregulation and greater risk taking by average US savers, so the political support for closing down the S&Ls was easier to assemble once the problem became clear (see Friedman's discussion).

Fifth, Japanese banks and bank regulators—more than those in any other OECD economy that faced a financial crisis—through much of the 1990s had an absence of macroeconomic assistance. The Japanese economy did not sustainably recover, and neither fiscal (up until 1998) nor monetary (throughout the decade) policy was of much help.⁶ Even if regulatory forbearance on the bank-by-bank level is mistaken, growth of the economy as a whole is an aid to resolving financial crises. As Mikitani points out, "If this structural policy [of tightening supervision and closing banks] has a depressive or a stimulative effect on the economy, it must be accompanied by the appropriate macroeconomic policy to offset this effect." Whether and how best Japanese monetary policy can respond to this challenge is discussed in the second half of this book.

Most of these differences, however, imply no distinctions between the right course of financial policy to pursue in Japan, the United States, or elsewhere. They simply highlight what we know, that both the economic

6. Posen (1998) examines the fiscal and monetary policy failures in Japan up through mid-1998; the essays in this volume by Bernanke; Jinushi, Kuroki, and Miyao; and Posen detail the unresponsiveness of the Bank of Japan to slowing growth.

costs of inaction and the political opposition to action were higher in Japan's financial crisis. In fact, these two outcomes were interrelated. Friedman writes: "The message from this experience is that delaying action—in the hope that either a change in the economic environment or some independent development may turn matters around, or perhaps merely out of an inability to overcome political or administrative obstacles even after everyone recognizes what needs to be done—is a policy with a price." And this is likely only a difference in degree—Glauber believes that "in both countries, there is little doubt that the government's timidity in informing taxpayers of the full cost to resolve the crisis produced a large, unnecessary delay. The delay in both cases turned a relatively small cost into a staggeringly large one. Dealing with these crises takes political leadership, a quality often not in large supply."

It is the matter of what Japanese policy should do about falling land prices, and the illiquid market for distressed real estate assets, that splits this volume's contributors. Shimizu argues in his essay that, given the sheer size of the Japanese land price and collateral problem in the past decade (which he documents)—both in terms of the relative decline in land prices and the overwhelming share of financial commitments backed by land—it was understandable for financial authorities to be reluctant to engage in some interventions and force loan foreclosures. There simply is too much distressed real estate to allow for securitization and selling off. Moreover, trying to resolve the problem all at once might provoke a further free fall in the real estate market, if not a renewed crisis of financial confidence in Japan. While holding supervisors and the convoy scheme accountable for putting the Japanese financial system in this situation, Shimizu sees no clear path or policy option to resolution so long as land prices are depressed.

Glauber responds that "loans and mortgages on the balance sheets at US S&Ls were under water as well, and any sale through securitization or other means required recognizing losses" in the United States, just as it would in Japan. For the individual banks and their incentives, the situation is the same. More important, Friedman and Glauber agree, the dynamics of real estate markets relevant for policy are the same as well, and mandate rapid sales. Friedman notes that "it is easy to overstate concerns about the effect on real estate values due to sales of assumed loan collateral. . . [but] the medium- to longer-run effect of eliminating the overhang of real estate held for sale was often beneficial. Everybody knows this collateral will have to be sold sooner or later. Actually putting it on the block clears the air rather than spoiling the market." Glauber argues that holding off on liquidation actually makes things worse: "Markets do not recover when there is a large inventory overhanging them, waiting for sale."

Those Japanese banks that themselves remain under water after the sale of their collateral and the writing off of their bad loans must be

closed. This is not merely a matter of policy to prevent the accumulation of more bad debt driven by moral hazard, and the wasting of public money (directly through squandered capital injections or indirectly through deposit insurance obligations). The long-term pressures on banking systems that began the move toward deregulation and the loss of high-quality corporate borrowers, and therefore that underlay the Japanese financial crisis, remain. “Even aside from the credit problems that reached the level of crisis, the banking industries in both the United States and Japan have for some time faced the need to downsize and restructure, but in neither country is the road to renewed profitability clear,” notes Friedman. In his essay, Anil Kashyap “suggest[s] that any policy proposal to address the continuing problems of the banks first be evaluated by checking whether it is consistent with the view that the Japanese banking sector needs to shrink.” Both Mikitani and Glauber discuss the positive but still shaky trend toward consolidation through mergers in the Japanese banking sector.

It must be acknowledged that Japanese financial policy changed significantly with the passage of legislation by the Obuchi government in October 1998,⁷ although it has by no means resolved the financial problem. The legislation made available significant public funds for capital injections into viable banks (thereby reducing the extent of the moral hazard problem in lending), set out strict conditionality for the terms on which the banks could apply for this public capital (thereby removing the moral hazard problem in capital injections), and created a mechanism for nationalizing failed banks. This was implemented by the Financial Reconstruction Commission (FRC) founded in June 1998, which oversaw the new Financial Supervisory Agency (FSA) that had been split off from the Ministry of Finance. Japan has been very lucky in recent years to have, on the part of the bank supervisors who had left the ministry, a surprisingly strong spirit of zeal and commitment, as well as independence.

The Obuchi government’s legislation gave the FRC and FSA real teeth with which to threaten the major banks. Not only were totally new intensive audits required before capital injections, but the banks had to give the FRC significant amounts of preferred shares in return for the capital. Under the terms of the agreements negotiated bank by bank, there was a sliding scale of when the preferred shares became options to convert into voting shares—for weaker banks asking for more capital, the share conversion became available earlier. If the bank’s capital ratio fell below the mandated level (4 percent for domestic banks, and 8 percent for major banks engaging in international transactions) after the option date, the FRC could vote out management or even take over the bank. Meanwhile,

7. Eisuke Sakakibara’s essay discusses this legislation as the culmination of a long process, notably influenced by the demands of the US government for conditionality in the injection of public funds.

if the banks chose not to take the public capital injections, they would be subject to nationalization anyway when their capital eroded (and all Japanese banks had weakened capital at this point). In all, by 1 April 1999, ¥7.5 trillion in new capital had been injected into all but one of the top 15 banks and all the important regional banks.⁸

As far as the new legislation was applied, the turnaround was extremely stark. Between October 1998 and April 1999, the Japan premium in inter-bank lending disappeared, savers shifted some deposits back into (selected) private banks and out of postal savings and cash at the margin, and the Japanese stock market rewarded bank stocks differentially. The FRC's nationalization of Long-Term Credit Bank on 23 October 1998 and (in a much quicker preemptive manner) of Nippon Credit Bank on 14 December 1998 clearly demonstrated that the law would be enforced. Savers, other banks, and purchasers of Japanese bank stocks (which had been rising steadily in the preceding year) all voted with their cash allocations that they found the cleanup credible as far as it went.

What is most important for our understanding, however, is that this partial financial cleanup provided the perfect natural experiment to verify that the dynamics of the Japanese financial crisis are indeed the same as those of its predecessor in the United States and in the standard sequence given above. For the large banks and their customers affected by the legislation, the policy-induced shift was right along the lines of an economic textbook—what had been an inefficient pooling equilibrium, wherein no banks could be distinguished from one another due to the convoy system and lack of transparency, was replaced by a more efficient sorting equilibrium, wherein the banks that could make themselves credibly solvent were rewarded by savers and markets rather than dragged down by the risks of their insolvent competitors.

The injection of new capital changed the incentives of the banks to stop rolling over bad loans or gambling on additional risky projects, as seen, for example, in the new policies of Shinsei Bank (formerly LTCB) toward Sogo's bankruptcy. Although this removal of moral hazard may have contributed to a minor credit crunch as banks with some equity newly at stake sought to rebuild their balance sheets, this was a necessary step, and the credit crunch was itself an indication that the policy was having the intended effect.

For comparison, those smaller, regional Japanese banks, on which the strictly conditional capital injections were not imposed, have continued largely with their business as before, including the rollover of nonper-

8. Five of what had been the top 20 banks had been forced by the FRC to move down a tier and out of the international markets. The politically sensitive smaller regional banks, with their loan portfolios to small and medium enterprises, have so far been spared such forced audits and conditional injections, despite their far worse condition than that of many of the major Japanese banks.

forming loans and the retention rather than sale of collateral. They also have not shown the same tendency toward mergers that the large banks have. Again, even the biggest recapitalized banks in Japan are not yet models of market efficiency, and the consolidation meant to result from their announced mergers remains to be seen—the October 1998 legislation has only dealt with a part of the Japanese financial problem. But the response to that legislation illustrates just how well economics does understand what needs to be done, even in Japan.

Monetary Differences

Developments in Japanese monetary policy in the past decade have displayed increasing divergence from Group of Seven (G-7) norms. As this book goes to press, deflation has been allowed to continue for more than 3 years of nearly monthly price declines on all major indices, and uncertainty about the justifications for the Bank of Japan monetary policy has mounted. Only three other OECD economies have experienced any deflation since the Depression, and in all three the central banks acted to reverse deflationary trends within a few months.

The BOJ has also resolutely refused to compensate, through looser monetary policy, for any contractionary effects of structural change, and has at times indicated that it wishes to tighten conditions despite the lack of sustained recovery.⁹ In fact, on 10 August 2000, despite overt government opposition and widespread financial skepticism, the BOJ raised its overnight interest rate from zero to 0.25 percent, its first interest rate increase in 10 years. This increase ended the BOJ's "Zero-Interest-Rate Policy" (ZIRP), which had been in place since February 1999. Any one interest rate movement in a time of economic hardship, such as that in today's Japan, hardly ends the policy debate—in this instance, it only underlined the differences of opinion between BOJ insiders and the majority of outside monetary economists.

Monetary policymaking is never easy, and central banks' decisions are always subject to a wide range of conflicting opinions. The existence of even widespread criticism of a central bank does not necessarily indicate that the criticism is justified. Moreover, at times history has vindicated the central banks that pursued strategies that differed from those prevalent at the time among their brethren—certainly, the Bundesbank and the Swiss National Bank earned a great deal of credibility for maintaining relative price stability in the face of the 1970s oil shocks at equal or lower real cost than the at first overaccommodating, later disinflating central banks in the rest of the industrial economies.

9. Jinushi, Kuroki, and Miyao's and Posen's essays below document BOJ officials' own explanations of the Bank's strategies.

There are also times when the criticism of central banks is flying, both contemporaneously and retrospectively, but no consensus on the right monetary policy exists, even among thoughtful observers. Such an instance is the Bank of Japan's handling of the Japanese stock market and real estate bubbles of the 1980s. Some argue that the BOJ was too loose with policy for too long after the 1987 Louvre Accord, contributing to or even causing the bubble, whereas others argue that the BOJ was too tough in trying to "prick" the bubble, and that central banks only cause harm by attempting to do so (both camps are represented in the essays that follow in this volume).

This argument has echoes in the present US monetary policy situation, in which some believe that the Federal Reserve has been too threatening, if not too tight, toward stock market developments, while others believe that Chairman Alan Greenspan dropped the ball by speaking about "irrational exuberance" in December 1996 but not following up with a significantly tighter monetary policy—all this dispute in a context where the current central bank leadership is revered, and where economic growth and price stability have gone hand in hand for nearly a decade.

It is precisely because of the difficulty of monetary policymaking that practical analysis of difficult situations is necessary. And no situation in the past 15 years has appeared to be more difficult for a central bank and therefore more worthy of study than that of Japan. First, in the late 1980s, there was the rise of the asset price bubbles, unaccompanied by any signs of broader price inflation in the Japanese economy—a dilemma for any central bank, and one that repeats itself in the United States of the late 1990s. Following the stock and land market collapses, there came the challenge of recognizing and responding to debt deflation amid all the confusing signals given by a financial system undergoing deregulation and numerous distortions from efficiency (as discussed in the preceding section).

When the financial crisis became overt by 1997, and Japan's banking system was critically weakened, the specter was raised of a "liquidity trap" in Japan wherein expansionary monetary policy would be ineffectively "pushing on a string."¹⁰ And throughout this period, Japanese economic policy was subject to pressure from the US government, sometimes directly affecting monetary policy in the form of either specific policy demands or movements in the yen-dollar exchange rate. But just as the existence of criticism does not always indicate that it is justified, by the same token, the appearance of challenging conditions does not necessarily imply that the choice of correct policy response is difficult. Even some of the apparent challenges might themselves be the result of, rather than a constraint upon, monetary policy decisions).

10. Most notably, see Krugman (1999)—although it should be noted the Krugman argued that a sufficiently expansionary monetary policy would have a real effect on the Japanese economy.

The second half of this volume is dedicated to such a study of the difficulties that have confronted the BOJ since the start of the bubble; the potential policy responses to them, both taken and ignored; and the motivations—economic, international, and political—for the strategies pursued. Underlying all these analyses is an implicit benchmark set by the Federal Reserve, which during this same period has been widely thought to have conducted an excellent monetary policy that contributed to the surprisingly strong performance of the US economy in the 1990s. A critical question is how much the Bank of Japan simply faced far more difficult problems than the Fed due to the Japanese economic situation, and therefore had to pursue a different path—rather than the Bank itself deepening or even causing the problems through its choice of policies.

In this context, it is first worth recognizing that when the Japanese economy was growing strongly in the 1970s and 1980s, the Bank of Japan pursued a monetary strategy much like that of the best central banks in the major economies. It is true that, until April 1998, the Bank of Japan was under the direction of the Ministry of Finance, rather than having independence like the Fed or the Bundesbank. Contrary to most presumptions about the response of central banks to political control, however, from the mid-1970s to the end of the 1980s the Bank of Japan delivered far more effective price stability than its lack of legal independence would have predicted.¹¹

In its mouthing of monetary targets without actually following them, its intermittent response to the dollar-yen exchange rate as necessary, and its gradualism in responding to price shocks, the Bank of Japan behaved in every way like the typical OECD central bank of the period, if not better.¹² As was already noted, the lack of a preemptive response to the asset price bubble that emerged at the end of that period may indeed, upon reflection, turn out to be mistaken. But if it was a mistake, it was one that could hardly be considered atypical of central banks, either then or today—in Japan in the late 1980s, there was neither meaningful domestic price inflation nor excessive output movements nor an overt banking crisis, which together constitute the proximate targets to which central banks usually react.¹³ Meanwhile, all central banks, including the Federal Reserve under Greenspan, seem to be reluctant to aggressively deflate potential asset price overvaluations.

In the 1990s, however, the Bank did take a course that diverged from usual practice. It spent most of the decade denying itself a role in reflating

11. Walsh (1996) discusses the Bank of Japan's outlier status in performance before independence.

12. A useful history of Bank of Japan monetary policy documenting this interpretation is Cargill, Hutchison, and Ito (1997).

13. See Bernanke and Mishkin (1992) and Mishkin and Posen (1997).

the Japanese economy, first by claiming that the situation was not serious, then by suggesting that its series of interest rate cuts would be sufficient, and then by asserting that domestic banking problems and international pressures constrained policy from a more aggressive response. All this took place with the approval, if not under the direction, of the Ministry of Finance, without much in the way of public accountability. In April 1998, the Bank of Japan gained independence from direct government control of monetary policy, and a new Monetary Policy Board of mostly outsiders was appointed to serve with Governor Masaru Hayami. This institutional change took place as part of a backlash against the failures of both the Ministry of Finance and the Bank itself in the area of financial supervision.

As with all central banks gaining independence in the 1990s, the Bank's mandate was set to maintain price stability, and the decisions about when to move interest rates how much (and whether to engage in open-market operations) were shifted to the Bank's control.¹⁴ In keeping with the current fashion among most central banks, the new arrangement was accompanied by increased transparency, which included formal commitments to promptly issue minutes of board meetings and public explanations accompanying interest rate changes. Unfortunately, the Bank of Japan has remained opaque in the most significant way, by failing to publicly specify either the medium-term goal of its policy or its intermediate target.

Thus, it is up to economic researchers to determine *ex post* what strategy actually guided the Bank of Japan's policymaking from the late 1980s to the present. In their essay for this volume, Toshiki Jinushi, Yoshihiro Kuroki, and Ryuzo Miyao estimate a "good policy rule" for the Bank of Japan, based on a Taylor rule fit to the BOJ's reaction function during the 1975-85 period. As with most previous research applying Taylor rules to other countries' monetary policies, a policy reaction function that takes both inflation and output into account (roughly equally) does a very good job of predicting interest rate movements for the BOJ.

Extending this rule through the end of 1998, Jinushi, Kuroki, and Miyao find that "there seem to be four major deviations [of the BOJ from the estimated good policy rule]: 1. The delay in policy restraint, 1987-88; 2. Insufficient policy restraint, 1990-91; 3. The delay in easing policy restraint, 1992 to early 1995; 4. The delay in easing policy restraint, 1997 to early 1998." In short, their analysis indicates that the BOJ was behind the curve in responding to the Japanese bubble, and has been too tight for most of the time since.

In keeping with most observers' assessments, the BOJ's initial deviation from the rule toward looseness in 1987-88 is ascribed to the Japanese

14. Exchange rate policy, including sterilized intervention, remained under the direction of the Ministry of Finance in consultation with the Bank, which also is typical of independent central banks (including the Federal Reserve).

government's commitment to expanding domestic demand as part of the Louvre Accord. Jinushi, Kuroki, and Miyao note that "the international coordination was reasonable in the sense that the attainment of economic prosperity should not involve sacrifices by other countries. However, we have to keep in mind that the policy coordination brought a change in the domestic policy stance." That change in policy stance, however justified, led to a diversion from what Jinushi, Kuroki, and Miyao see as a growing concern by the BOJ about the rising bubble—something that some might argue was mirrored in the Federal Reserve holding off on interest rate hikes in 1997-98 due to the Asian financial crisis.

What is interesting about Jinushi, Kuroki, and Miyao's evaluation is that they base it on their Taylor rule, which does not include an asset price value or inflation term along with regular consumer price index (CPI) inflation and the output gap. In other words, the BOJ was too loose in the late 1980s, even without taking stocks and land into account. This would be a happy result if it also meant the converse: that simply targeting inflation with sufficient responses to above-target inflation forecasts would be enough to prevent bubbles along the way.

Jinushi, Kuroki, and Miyao, and Blanchard, however, do think that the BOJ should have taken the Japanese asset price bubble directly into account. Blanchard shows in a simple model that targeting inflation without targeting the bubble "keeps output stable as the bubble grows. But it may imply a very unpleasant aftermath once the bubble has crashed: a lot of useless capital, serious collateral problems for firms, and thus a potentially low natural level of output for some time after the crash." This image is, of course, familiar to anyone who has seen the Japanese economy since its 1992 stock market crash. Assuming that a stock market bubble biases firms toward overinvestment, it may be worth even some sacrifice of growth through a tighter policy to prevent this kind of capital boom-bust cycle.

The problem is one of timing: A central bank should not prevent every run-up in stock prices, so it must allow the bubble to get under way before it can recognize one (it hopes) and then react. Blanchard states, "What is proposed [in his essay] is a policy designed, if not to prevent bubbles, at least to prevent them from becoming too big." But if the bubble is growing without transmitting price pressures to the rest of the economy, as was the case in Japan, and if the country is already at a low level of inflation, the real economic cost of pricking the bubble can be quite high, perhaps even in comparison with the aftermath of overcapacity. Given the long and uncertain lags between monetary policy decisions and their effect on the real economy, one can have the worst of both worlds: a bubble burst so late as to have a large negative impact, and a monetary contraction so late in affecting the real economy that it amplifies the harm done by the bubble. These concerns are part of the motivation

for Ben Bernanke's belief, stated in his essay below, that a central bank that targets inflation but does not try to prick asset bubbles will on balance do better.

Conversely, if the bursting of a bubble once begun is inevitable, and if central banks ignoring asset price movements just allows the bubble to grow bigger, preemption may indeed save money. Blanchard states, "Admittedly, the choice facing the central bank [between ignoring the bubble or not] is not pleasant. But this is not the point. The point is that the right strategy is likely to be somewhere in between the two pure strategies, that is, to tighten money more in the presence of a bubble than is implied by inflation targeting [alone]."

Of course, this depends on the central bank having some idea of when a bubble is occurring. The ability of the Federal Reserve to ascertain that positive structural change was underlying US growth in the 1990s, and therefore that stocks were not dreadfully overvalued, may turn out to be remarkably prescient. But—given the endogeneity of the value of investments to the growth of the economy—one cannot yet be sure. Japan in the 1990s is a cautionary example of how investments whose high returns once seemed structural turned out to feed a cyclical downturn when the bubble burst. Blanchard is right to point out that "one natural objection at this point is that the central bank knows little about the 'natural P/E ratio.' The point is well taken, but it applies to at least two other components of the Taylor rule: How much does the central bank know about the natural interest rate, and about the natural level of output?" The Japanese experience alone does not settle this issue, especially because the central bank's and private estimates of Japan's potential output varied in line with stock market expectations.

In looking at the past decade, it rapidly becomes clear that the BOJ's policy stance has gone from too accommodative to insufficiently so. As Blanchard reminds us in his comments on Jinushi, Kuroki, and Miyao's essay, "The Phillips curve wisdom remains largely true in modern treatments of the determination of prices, wages, and output: If output is above its natural level, then we are likely to see inflation increase. If it is below, inflation is likely to decrease. As inflation is slowly decreasing today in Japan, this strongly suggests that output is below its natural level."¹⁵ Despite this obvious indicator of deficient demand, discussed as well in the opening of Bernanke's essay below, Jinushi, Kuroki, and Miyao observe: "The problem [from 1992-95] was that the BOJ might have misjudged how serious the economic situation was, so that the pace of monetary loosening lagged events. Of course, the BOJ knew that the large amount of debt prevented the economy from recovering and that the

15. For a more detailed econometric assessment of Japan's growing output gap in the 1990s, see Posen (1998, chap. 1 and appendix).

economy was still in a severe condition. . . . However, as far as we can tell, the BOJ did not use the expression of ‘deflationary gap’ or ‘debt-deflation’ in the early 1990s. . . it therefore can be interpreted as a delay in judgment by the BOJ during that time.”

It turns out, however, that the BOJ’s tight money policy was not solely a matter of misjudgment of the situation, it was also a reflection of a shift in priorities. Using two different econometric methods, Jinushi, Kuroki, and Miyao establish that the weight the BOJ put on inflation goals relative to real output concerns rose significantly in both statistical and economic terms after 1987—and two other recent studies independently confirm this result.¹⁶ This is a clear divergence from the relative balance between output and inflation goals, and the tendency to respond to whatever macroeconomic variable under the most stress at that time (which in Japan would have been real output), that characterizes most central bank behavior, including that of the BOJ before 1987.

There is strong economic justification behind the central bank consensus in practice that output goals should be taken into account, and that price stability should not be pursued too aggressively when the economy is already at low inflation. In a world of sticky nominal contracts, especially debt contracts, with resistance to price and wage cuts, sharp increases in interest rates near zero inflation have a depressing and destabilizing effect on the real economy. In macroeconomic terms, the Phillips curve becomes flatter as one approaches zero inflation, with a larger movement in real output required for a given change in inflation. A wealth of theoretical and econometric evidence supports the claim of Jinushi, Kuroki, and Miyao that “imposing a larger weight on inflation under a low and stable inflation environment implies that the central bank is simply content with the fact of low and stable inflation and does little to stabilize the real economy. Consequently, with [a flattening Phillips curve and a greater relative weight on inflation goals] combined, the business fluctuations could actually become unprecedentedly large, as we observed they did in the late 1980s and early 1990s [in Japan].” This is why most central banks in the industrial economies target an inflation rate of 2 percent or more, whether or not they announce that target, and why they expand in response to weakness in aggregate demand. This is why I maintain in my essay for this volume that “the BOJ’s policy was not neutral or at its limit [with its rate cuts in the 1990s], and the Japanese economy was not going its own bad way, despite monetary efforts. In fact, . . . the deflation and real volatility [seen] were exactly what any monetary economist would have predicted to be the result of pursuing tight monetary policy at zero or negative inflation in an advanced economy.”

16. See Bernanke and Gertler (2000) and Kuttner and Posen (2000), who also identify a structural break in the BOJ’s reaction function, toward the more counterinflationary, in 1987.

Leaving aside the question of how it got there, once the independent BOJ found itself in 1998 facing a deflationary situation, with a fragile banking system, and little room (after February 1999, no room) to cut the nominal interest rates under its control, what could be done? In a widely cited working paper (strongly promoted by the BOJ), Okina (1999) argued that once interest rates had been cut to zero, there was nothing else the BOJ could do to stimulate the economy. Money creation would be ineffective because banks (rebuilding their balance sheets by holding onto Japanese Government Bonds, or JGBs) would be unwilling to lend, and announcement of an inflation target would be ineffective if not further destabilizing because it could not credibly be attained. Governor Hayami and other senior BOJ officials made this argument in public with their reaffirmation that the ZIRP was not only as far as they could go but actually was an expansionary monetary policy. This BOJ stance was at odds with the norms of central banks, as seen not only in the types of estimations of policy reaction functions done by Jinushi, Kuroki, and Miyao, but in the criticism leveled at the BOJ by economists in other central banks. For the most part, this criticism came in veiled academic form, in a circuit of conferences about the conduct of monetary policy in a low-inflation environment, and about the possibility and implications of a liquidity trap, held at various central banks and research institutions during 1999.

As Bernanke argues in his essay, “Contrary to the claims of at least some Japanese central bankers, monetary policy is far from impotent today in Japan. . . . First—despite the apparent liquidity trap—monetary policymakers retain the power to increase nominal aggregate demand and the price level. Second, increased nominal spending and rising prices will lead to increases in real economic activity.” This is because loose policy is not a matter of just the nominal interest rate, but of inflation expectations. He further writes: “One only need recall that nominal interest rates remained close to zero in many countries throughout the Great Depression, a period of massive monetary contraction and deflationary pressure. In short, low interest rates may just as well be a sign of expected deflation and monetary tightness as of monetary ease.” The key is to turn around those deflationary expectations.

Bernanke proposes, and Blanchard seconds, the idea that the BOJ use a positive publicly announced inflation target combined with the expansion of the money supply and/or depreciation of the yen (both through the printing of yen by the BOJ). On the basis of simple arbitrage arguments (modeled in Blanchard’s essay), Bernanke shows that the idea that BOJ purchases of JGBs or dollars would be ineffective comes to a *reductio ad absurdum*—the Bank could simply keep issuing yen, and keep purchasing assets, until it owned an unlimited amount of either the Japanese or the US economy’s capital stock, if those receiving the printed yen did not

spend them. But if they spent the yen, Japanese nominal income and the price level would indeed rise.

The inflation target announcement speeds the process and reduces the public's uncertainty about the BOJ's plans. Bernanke explains, "On the issue of announcement effects, theory and practice suggest that 'cheap talk' can in fact sometimes affect expectations, particularly when there is no conflict between what a 'player' announces and that player's incentives. In technical language, announcements can serve as equilibrium selection devices." If the Bank wishes to raise the Japanese price level, it has nothing to fear from telling the public what it intends, and it may find its job eased by so doing. As Blanchard observes, "This use of monetary policy [to create promised inflation] has often been presented as rather exotic, perhaps too exotic to be relied on. . . . In fact, this use of monetary policy is far from exotic. Indeed, one can argue that monetary policy works mostly—entirely?—through its effects on expectations." That is not to say the announcement alone is enough, because the money must actually be printed until the announcement is believed, and there are ways of distributing the printed money that are more likely than others to have the desired effect. Blanchard, for example, prefers drawing attention to the effect on the yen-dollar rate because "the decrease in real interest rates [due to monetary expansion] will not be directly visible. But the increase in the nominal exchange rate will. This will allow both the central bank and the financial markets to assess the credibility of the new policy."

The practical aspects of implementing a more expansionary policy under the present circumstances of financial fragility have been of great concern to the Bank of Japan. Even when BOJ officials began to admit that they could create inflation, despite being at zero nominal interest rates, they raised issues with the likely side effects of so doing. What would happen if an inflation target were announced, only to be missed, given the uncertainties of money creation with a damaged banking system? What would be the effect on fiscal policy and the banking system if inflation were to suddenly spike upward? In my contribution to this volume, I agree that "it is, no doubt, true that the BOJ at present would not be able to move inflation as predictably as in the precrisis era. . . . And it would be difficult to predict the necessary size and lags of such [open-market] purchases to have the desired effect [in the absence of the normal instrument]. But, so what? Just because a policy is difficult to implement precisely does not mean that it carries enormous risks. . . or that the policy cannot be the best of available alternatives."

The alternative to the BOJ conducting a more expansionary policy, and anchoring expectations with an inflation (or other nominal) target, is the costly course it is already on, as discussed by Jinushi, Kuroki, and Miyao: deflation, volatility in the real economy, and uncertainty in financial markets. And whatever one thinks of Japanese politicians' proclivities for

public works spending, the BOJ's pursuit of positive inflation through the limited monetization of JGBs need not open the floodgates. In the words of Bernanke, "Cooperation with the fiscal authorities in pursuit of a common goal is not the same as subservience." This is just as true for an independent central bank as for a dependent one—consider the interaction of the Federal Reserve and the Clinton administration in the 1990s. In general, Bernanke suggests, "It is better for the public to know that the BOJ is doing all it can to reflate the economy, and that it understand why the Bank is taking the actions it does. The alternative is for the private sector to be left to its doubts about the willingness or competence of the BOJ to help the macroeconomic situation."

Given the economic arguments and the obviously outlier behavior of the BOJ, as well as the persistence of deflation, it is not only the Japanese public that is left wondering why the Bank of Japan has chosen this course of deflationary policy. It is also a matter of profound significance to political economy. As I note below, "For the past 20 years, both academic and practical discussions of monetary policy mostly have been about how to keep central banks from allowing *too much* inflation. . . . Then one comes to the Bank of Japan in the past decade. Suddenly, the problem is not keeping inflation from rising, but how to keep the price level from falling." An answer is not easy to come by, even when one takes political factors into account. Most independent central banks, including new ones eager to establish their credibility, do not so publicly challenge the prevailing opinion of both elected officials and mainstream economists as did the Bank of Japan in the past 2 years.

Between a process of elimination, and careful reading of the statements of BOJ policy board members, I am led to the conclusion that a desire by the BOJ to promote structural change in the Japanese economy is a primary motivation for the Bank's passive-aggressive acceptance of deflation. Leaving aside the doubts about whether a tight monetary stance on net does the Japanese economy good, or even in partial equilibrium enhances structural reform, the ability of this justification for the BOJ's policies to survive extended public scrutiny seems dubious. It is only because the BOJ is not held accountable for attaining a publicly announced policy goal, as most independent central banks are, that it can pursue this course—with a requirement to publish a target, the BOJ would have to acknowledge that it is actually targeting zero inflation by pursuing its current policies, and then defend that goal. Jinushi, Kuroki, and Miyao argue in their essay that a public inflation target in Japan today would be interpreted too strictly, which would induce real instability. My interpretation is the opposite, that the lack of an explicit inflation target allows the BOJ to pursue price stability at all costs.

An alternative explanation for the Bank of Japan's monetary policy in the past decade, and in fact for the fluctuations in the Japanese real

economy, is put forward by Eisuke Sakakibara in his contribution to this volume. Sakakibara, a former Japanese vice minister of finance for international affairs, argues that US policy demands upon Japan, at times motivated by mercantilist or populist pressures for trade relief, drove both the yen-dollar exchange rate and financial developments in Japan. "These three periods [recession, 1992-94; recovery, 1995-96; and deflation from financial crisis, 1997-98] describe the evolution of the Japanese economy, and correspond somewhat with changes in US economic policy toward Japan. This is no coincidence. Throughout these three periods, Japan-United States relations and foreign exchange and equity markets played a very important role." This argument dovetails with the academic work of Ronald McKinnon, who maintains that mercantile trade pressures from the United States have created ongoing expectations of yen appreciation against the dollar (because that is the only way seen to reduce the US bilateral trade deficit with Japan), and that expected yen appreciation is the driving force behind Japan's recession of the 1990s.¹⁷

For example, rather than attributing the Japanese recession of 1993-94 to the effects of the bubble on the financial system described by Shimizu, and to the tight monetary policy that Jinushi, Kuroki, and Miyao discern, Sakakibara writes: "Prospects for a Japanese recovery that existed during 1993-94 were dashed as the strong yen canceled out the initially favorable signs of an upturn in domestic demand. . . . The Japanese recovery thus was delayed by as much as a year or a year and a half because the yen was too strong, which was the result, to a significant degree, of tough, populist, election-conscious US policies."

According to Sakakibara, even the timing and extent of public capital injection into the Japanese banking system were determined by US pressures. "Up to [September 1998], the US Treasury was emphasizing the liquidation of insolvent banks and expeditious downsizing and restructuring of viable banks. . . . However, in September, in the midst of suffering from the Long-Term Capital Management problem themselves, the US authorities. . . demanded that the Japanese government increase [the public funds], . . . and that the funds be infused as quickly as possible. . . . This was a boon to the Japanese government because US ambivalence about the infusion of public money had been a big factor in making Japanese public opinion largely antagonistic toward such infusion."

Jeffrey Shafer, Sakakibara's onetime counterpart as US undersecretary of the treasury for international affairs, views the same period quite differently. In his essay below, Shafer argues that "whatever the [Clinton] administration's goals with respect to economic relations with Japan, their pursuit had nowhere near the impact on the exchange rate or on the Japanese economy more broadly as did the fundamental economic forces

17. See, e.g., McKinnon and Ohno (1997).

at work. . . . If US pressure had been more successful in stimulating structural reforms or in encouraging growth policies, it would have had a stronger impact.” He attributes the 1993-94 appreciation of the yen against the dollar to a combination of budget tightening in the United States (reducing interest rates), capital outflows, and markets acting to limit the US trade deficit, not to trade negotiations. According to Shafer, “The yen. . . began to recover [in late 1998] when new fundamentals did emerge: a change of policy in Tokyo that brought meaningful fiscal stimulus, an effective response to the banking crisis, and a resumption of growth.” These policies certainly were welcomed in Washington, but it was the Obuchi government’s decisions that led to the change in exchange rates, not an increase in US “pragmatism” (as Sakakibara characterizes it) with regard to the Japanese bank bailout.

The contrast between Sakakibara’s and Shafer’s interpretations of events during the past decade not only sheds light on the differing perceptions on opposite sides of the trans-Pacific table—it also emphasizes how potentially important international factors can be to monetary policy decisions and outcomes. Unquestionably, the United States was exerting pressure on Japan for specific policies during the past decade, first for trade opening, and later for macroeconomic stimulus and financial reform. Also, unquestionably, the US government felt quite frustrated by the lack of response of the Japanese government to its own domestic recession, let alone the US requests.

If Sakakibara is right that the United States effectively used exchange rate markets as a means of commercial policy, then whether or not the United States chooses to participate in joint intervention efforts is a critical signal to the markets, and has a direct influence on the Japanese economy. Such a world also renders questions of what the BOJ should or should not be doing largely irrelevant. Yet the United States pursued a “strong dollar” policy for most of the period in question, and, as Sakakibara himself notes, on many occasions joint interventions had no or the opposite effect on the yen-dollar rate from that intended. In the words of Shafer, “The record strongly suggests that the fundamentals drove the exchange rate and these exchange rate movements drove the perception of statements. It was not the statements or the sterilized intervention that created the durable movements in the markets.” If that is a fair characterization, the Bank of Japan’s own policy choices are indeed significant.

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