

Book Review on
***Monetary Policy with Very Low Inflation in the Pacific Rim*, Edited by Takatoshi Ito**
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During the 1970s and 1980s, Japan was under the spotlight. As many researchers investigate China to meet their curiosity nowadays, scrutiny on Japan and its economic management was a popular subject in the economic literature. Their efforts to explain the country's post-war miraculous growth contributed to development of academic economic fields such as international trade and economic development. As soon as the 1990s broke out, as the economy started experiencing a long-lingering recession, so did the general curiosity on the country dwindle, but certain aspects of the economy came under a different spotlight of scrutiny. That is, deflation and the liquidity trap. Starting with assets deflation in the early 1990 and penetrating into goods markets by the mid-1990s, Japan's deflation became one of the most hotly debated issues among macroeconomists. By the early 2000s, the literature on the issue of deflation, the liquidity trap, and how to manage monetary policy in such an environment flourished for the first time since the 1930s.

The book is a nice addition to the literature on the exact issue. It provides a set of interesting articles by the economists who have been on the forefront of the research on deflation and monetary policy. The articles shed light on the difficulties and complexities monetary policy makers may have to face in a deflationary environment and can be a good guideline for central bankers facing with deflation or extremely low inflation. Furthermore, this book could not be more timely. The famous zero interest rate policy (ZIRP), implemented by the Bank of Japan in 1999 to fight against deflation, ended in July 2006, and as of the time of writing, the Japanese economy finally started showing signs of steady recovery.

Although it seems that Japan's deflation is about to fade away, it by no means means that we do not need to have a good understanding of deflation. Rather, it is extremely important for policy makers and scholars to understand the mechanism of deflation and how to manage it through with appropriate monetary policy. This book accomplishes that goal. To introduce how it does nicely, let me discuss the implications of the Japanese deflation experience and why it is important to be knowledgeable of monetary policy in a deflationary environment.

The first implication of the Japanese deflation experience is surely that the debate on liquidity trap rekindled for the first time since the 1930s. Chapter 4 by Ito and Mishkin, which I recommend readers read first, gives an overview of Japanese deflation experience and its monetary policy over the period since the late 1980s. The authors are quite critical of the Bank of Japan for its policy management, but that indicates how difficult for central bankers to deal with a liquidity situation.

In a liquidity trap situation, the zero nominal interest rate or extremely low rates would make economic agents indifferent between money and bond, and also make monetary policy essentially ineffective. A combination of deflation and liquidity trap can lead to higher real interest rates and output stagnation, that can even further expectations of deflation and higher real interest rates, thereby causing a vicious cycle of persistent deflation and lingering recession. A wide variety of policy measures have been discussed to get an economy out of such a trap, but policy agendas are quite different roughly between the monetarist and Keynesian views. The monetarists view the liquidity trap solvable by implementing unconventional money easing – or “money gift” in Friedman’s words – such as Japan’s “quantitative easing” policy and direct purchasing by the monetary authority of corporate papers and long-term foreign and domestic bonds. In the Keynesian view, expansionary fiscal policy is the conventional measure to a liquidity trap. From this view, creating expected inflation can also be an important aspect of monetary policy as Krugman (1998, 2000) argues. Svensson (2001) extends this argument and suggests a fixed exchanged rate policy to create expected inflation until the liquidity trap situation disappears.

The first three chapters of this book, McCallum (Chapter 1), Robinson and Stone (Chapter 2), and Hur (Chapter 3) add interesting discussions to the theoretical literature on deflation and the liquidity trap. McCallum proposes a monetary policy rule that *avoid* deflation altogether, not the one to get an economy out of it. Using a simple open economy model, McCallum argues that a monetary policy rule based on a weighted average of the short-term interest rate and the depreciation rate helps an economy avoid deflation while maintaining the functionality of stabilization policy. This type of monetary policy can be particularly relevant to open economies such as those in East Asia. As the title of the book suggests, East Asia is not free of deflation. Beside Japan, China, Taiwan, and Hong Kong also experienced deflation around the turn of the century. The Taiwanese experience is carefully reviewed by Yang and Shea (Chapter 10).

More generally, deflation may not just be an East Asian phenomenon, but can occur in a country that experiences an asset price boom. The recent Japanese experience

has shown that deflation can occur in the aftermath of an asset price boom, and also that the possibility of a post-bubble deflation can pose a most challenging problem to monetary policy makers. That is, in the event bubbles in asset prices occur, central bankers face the necessity to tighten policy so that they can preempt inflation. However, tightening policy could overkill the bubbles and cause severe asset deflation from market meltdowns if monetary authorities did not loosen policy soon enough after the burst of the bubbles.

The intricacy and difficulty of monetary policy in such a situation is fully explained by Robinson and Stone's article (Chapter 2). Using a simple model, the authors depict monetary policy making when the economy is possibly facing a developing bubble and how it can be constrained by the zero lower bound (ZLB) on the nominal interest rates. According to the authors, the impact of policy measures can depend on whether they understand the stochastic properties of the bubble. In the literature, Bernanke and Gertler's (1999) argument – that central bankers should not attempt to incorporate the behavior of asset markets in their policy making unless the markets are sending clear signals about the state of inflation – seems to be a consensus. However, this chapter makes the issue of whether and how to incorporate asset price bubbles in monetary policy making still a highly debatable issue. It is also relevant to the current conditions in the world economy where emerging market countries, most notably China, seem to be experiencing asset price bubbles.

The Japanese experience has also reminded many economists that how severe the outcome of the deflationary fallout from a meltdown can be depends upon the level of development of financial markets in the economy – in terms of the effectiveness or existence of proper risk management and prudent financial administration, not of the market size. Generally, a banking industry lacking a system and/or skills of appropriate risk management tends to rely too much on collateral values of some real assets such as land, and underdeveloped financial administration often allows over-extension of credit during a real asset boom. Therefore, once the asset market crashes, banks can get easily riddled with non-performing loans, that can feed the market underperformance and severely worsen capital conditions of the banks, eventually leading to a spiral dwindling of the banking industry and the whole economy. And this is what happened in Japan during the 1990s, and something many countries, especially those which are experiencing a boom in asset markets and which have institutional weakness in their financial systems, can experience.

In underdeveloped financial markets, liquidity or depth of the markets can matter greatly; the liquidity can fluctuate more easily in shallow markets and the

markets can be more vulnerable to liquidity shocks, making the functionality of financial intermediary volatile. Furthermore, deflation can make this environment worse by hurting firms' balance sheets and also by making merely holding money more comparable to holding assets. On this issue, Choi and Cook (Chapter 8) make important contributions. Choi and Cook investigate stock market liquidity during the deflationary period in Japan. They show that the general liquidity level of Japanese equity markets declined during the period. Their empirical findings also show that firms with illiquid balance sheets and illiquid markets for their equity are more susceptible to liquidity shocks while their vulnerability is found to be correlated with the firms' performance. Using aggregated data, the authors also provide evidence that exogenous liquidity shocks can negatively affect money demand, interest rates, and output.

Last, but not the least, the Japanese experience of deflation made it clear that policy coordination between monetary and fiscal authorities can be extremely difficult. From the Keynesian view, fiscal intervention is an important tool to boost the aggregate demand especially when monetary policy is ineffective in a liquidity trap situation. However, as Japanese experience shows, fiscal expansionary policy can also lead to enlarging the public debt of the country, whose real cost can be increased by deflation. Iwamura, Kudo, and Watanabe (Chapter 6) and Ball (Chapter 7) look into the interaction between monetary and fiscal policy for Japan.

Ball's chapter investigates an interesting and ambitious question: how an economy facing a liquidity trap, as Japan did in the early 2000s, should implement fiscal stimulus so as to have an effective effect on output while avoiding dire long-run fiscal consequences. He finds that an expansionary fiscal policy on a substantial scale, whether financed by money creation or bonds, could bring about short-term recovery and lead the economy to a steady state with output at potential and steady inflation in the long-run while also improving the debt-income ratio. However, money finance can prevent the public debt from running up in the short-run that can arise with debt-financed stimulus policy. Hence, the "helicopter drops" of money, or money-financed fiscal stimulus is preferable to bond-financed one in a liquidity trap situation.

Thus, deflation and the liquidity trap have multidimensional implications on different sectors of the economy. However, from the 1930s to the 1990s, these implications were buried in monetary policy makers' efforts to lower inflation, that was prevalent in most of the central banks in the world especially in the post-WWII era. However, as Rogoff (2003) and others argue, more appreciation for central bank independence and credibility and globalization have made inflation come down to lower

levels for many countries including developing countries. Consequently, central bankers' policy management based on the asymmetrical interpretation that price stability means lowering inflation have started being questioned since it has been found to be inappropriate for an economy experiencing deflation and liquidity trap. A good example is found in Ito and Mishkin and Iwamura et al. in the book where the Taylor (1993) rule is found to be inappropriate for deflationary Japan. In other words, the Bank of Japan's incapability of dealing with deflation in the 1990s is partly because of the Bank's strong commitment to price stability in the asymmetrical sense. This is the reason why Krugman (1998) said the Bank of Japan should "credibly promise to be irresponsible." The Japanese deflation experience has shown that central bankers need to interpret price stability symmetrically so that they can also be prepared for deflation. Deflation can occur to any country, especially if it experiences asset price bubbles or economic crises. In order for policy makers to prepare, this book can be a good guide book.

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