Japan and the European Union in the global economy

GUNTRAM B. WOLFF AND MASAHIKO YOSHII, EDITORS

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Japan and the EU in the global economy: challenges and opportunities

GUNTRAM B. WOLFF AND MASAHIKO YOSHII

This book is the final output of a strategic European Union-Japan research partnership, which we initiated in order to deepen our understanding of two major economies facing similar challenges and opportunities. This publication brings together scholars from Kobe University and Bruegel along with selected outside contributors from Japan and the EU from government and leading policy institutions. The authors gratefully acknowledge the support of Milena Mathe and Olga Tschekassin for content revision and coordination between contributors.

Why is Japan a good case study to help Europe overcome the economic and financial crisis that started more than five years ago? What can Japan learn from Europe's experience? Japan and the EU are both open economies with significant trade and financial links; both face in many respects similar challenges. Both economies are affected by the rise of emerging market economies, which represent a huge opportunity but also imply the need to continuously adapt the production structure to the new competition. Both economies also face comparable internal economic adjustments.

Looking at the historical experience of Japan is helpful to draw some lessons for Europe today. Japan since the 1990s had to overcome the bursting of a housing bubble and to struggle with significant corporate balance-sheet adjustment. The significant

problems in Japan's banking system were not resolved for many years, impairing credit to new business endeavours and undermining growth. The banking system became unable to fulfil its financial intermediary function and was later labelled a 'zombie' banking system. Eventually Japan entered deflation. The combination of deflation and the so-called zombie banks is now commonly referred to as the Japanese disease. Only when the banking system was fundamentally restructured did Japanese banks start again to fulfil their credit intermediation function and provide credit to new and emerging firms instead of old corporations that were unproductive.

But, it is also useful to look at the current situation in Japan to draw out some lessons for Europe. Prime minister Shinzo Abe has started with 'Abenomics', one of the most interesting experiments in economic history. With a 'three arrows' approach based on a massive monetary expansion, flexible fiscal policy and plans for major structural reform, the prime minister intends to overcome deflation and re-invigorate economic growth. The initial monetary expansion had positive effects on the Japanese economy. Stock prices increased, the exchange rate depreciated significantly and deflation rates gradually came down and Japan may return to inflation soon. However, many challenges remain, in particular for the third arrow, namely structural reforms to increase productivity growth rates. These reforms are still ongoing and their success will determine the ultimate success of Abenomics. One could argue that only now is there hope that all the consequences of the boom and bust in 1990 can be fully and finally overcome.

Europe, in turn, is currently undergoing one of its most severe crises in recent history with similar balance-sheet adjustments happening in some parts of its economy. In Europe as in Japan, the role of monetary policy and banking policy in addressing and overcoming the crisis is hotly debated. Also the appropriate role of fiscal policy and structural reform is controversial in both economies.

This volume is divided into four parts covering the issues debated in depth during the conference on Japan and the EU in the global economy that took place at Bruegel in October 2013.

The first part focuses on the trade and financial links between the two economies in a period of rising emerging markets. The contribution by André Sapir proposes to look at the effects of Abenomics on Europe. Europeans are watching Abenomics with a mixture of hope and apprehension. The hope is that the economic strategy will succeed in reviving the Japanese economy. This would obviously be desirable for the global economy in general and for Europe in particular, where growth has been dismal for a

while. At the same time, there is some apprehension that the yen, which has depreciated against the euro by about 40 percent since September 2012, will continue to fall, unleashing declines of other Asian currencies against the euro. The second contribution is from Takuji Kinkyo. His paper summarises the progress of economic integration in East Asia and discusses how EU-Japan cooperation can contribute to promoting further integration. It examines the current state of trade and financial integration in East Asia and considers the policy implications. The progress of East Asia's regional financial safety net is assessed in the light of the EU model to discuss what lessons for Asia can be drawn from the recent European economic crisis. Finally, Michael Plummer discusses mega-regionalism in Asian trade deals and the deep involvement of Japan. He suggests that the EU has a strong incentive to link with these movements. Trade diversion might be small in the aggregate but could be substantial at the product level. An EU-Japan free-trade agreement would be a good step but it should be part of a revival of the multilateral trade agenda.

The second part is a comparative discussion between Japanese and European experts on housing bubbles, deleveraging and the appropriate structural response. The first contribution by Tomomi Miyazaki summarises the expansion and bursting of the Japanese land-price bubble in the late 1980s by analysing Japan's economic policy during that period. Miyazaki then describes the fiscal policy and corporate response in the post-bubble period. Public investment used as part of the stimulus package had asymmetric effects on corporate investment. The crowding-out effect observed in Japan might partly be attributed to the allocation of public investment. Investment predominantly to rural areas instead of urban areas does not contribute to promote greater corporate investment but rather hinders it. The lesson for Europe is that public investment should be used for the right purposes to address the massive drop in demand. The second contribution is by Joachim Fels. His chapter shows how 'Japanification' of the euro area is a serious risk. He relates the Japanese narrative and draws some parallels with the euro area. However, he argues that Japanification can still be avoided if euro-area policymakers heed three lessons from Japan: i) Monetary policy should move early and aggressively before deflation manifests itself; ii) Regulators should enforce a clean-up of bank balance sheets including a realistic assessment of bad assets and a swift recapitalisation where needed; and iii) Governments should avoid overly tight fiscal policies that could plunge economies back into recession. It is an important reminder for European policymakers.

The third part studies and compares the monetary policy response of the Bank of Japan with that of the European Central Bank, and the fiscal policy response in the context of a fragile financial system. In the aftermath of the global financial crisis, a

number of major central banks implemented unconventional monetary policies (UMPs). The first paper by Waturu Takahashi argues that UMPs are in theory and practice problematic from the perspective of central bank independence. As many central banks are now required to pursue three types of stability – price, financial and fiscal – there can be significant conflicts with government. In addition, the lack of a policy rule for UMPs erodes accountability. The author proposes here a new approach to central bank independence from the viewpoint of political economy. The second contribution by Zsolt Darvas is a discussion of the paper by Takahashi. Darvas underscores the risks to central bank independence in Japan resulting from the high public debt and budget deficit. A major challenge for the European Central Bank is to avoid fiscal or financial stability dominance in order to preserve credibility and independence. Three main issues are considered: the need for and the effectiveness of unconventional monetary policies, the appropriateness of fiscal adjustment strategies during the current crisis and the problems with low inflation.

Finally, part four is a discussion between high-level policymakers drawing lessons and making concrete policy suggestions for Japan, Europe and their economic relationship.

The first contribution by Kiyohiko G. Nishimura is a preliminary assessment of 'Abenomics' and the 'bold' monetary policy of the Bank of Japan. Nishimura sees a good chance of ultimate success for Abenomics. First and foremost, the Japanese economy is in a natural recovery phase from prolonged below-normal economic activities caused by a series of unexpected negative shocks such as the Fukushima nuclear power plant accident. Second, the public still has a favourable perception of the Abe cabinet and its economic policy, which brings political stability. However, it is absolutely necessary for the ultimate success of the Abenomics to learn from past policy experience, summarised in three dicta in the paper: avoid wishful thinking, be proactive and communicate effectively. The final contribution in the volume is from Peter Praet, Member of the executive board of the European Central Bank. He argues that protracted and large-scale balance sheet adjustments can weaken economic activity over a prolonged period. Repairing the financial sector was an important element in improving the Japanese economy. The lesson for the euro appears to be clear: the overhaul of the financial architecture needs to be accomplished in its entirety.

The one-day conference allowed a number of important exchanges on the challenges that Europe and Japan face. Clearly, Europe can learn from the Japanese experience. It should be a top priority for European policymakers to avoid falling into a Japanese

trap; more aggressive monetary policy and deep structural reform and financial sector reform are central in this regard. We will have to continue watching the (halfway) results of Abenomics and the response from Europe. Europe and Japan also have a clear interest in deepening their economic and trade ties, ideally in an enhanced multilateral trade framework. Japan, in turn, can learn from many of the discussions in Europe, for example on central bank independence. Bruegel and Kobe will continue the dialogue.

Part 1:

Trade and financial linkages between Europe and Japan: new evidence and scope for improvement

What Abenomics means for EU-Japan trade relations

ANDRÉ SAPIR

1. Introduction

For two decades the Japanese economy has suffered from deflation and stagnant nominal GDP. Real GDP and per capita GDP have grown slightly but only on the back of chronic fiscal deficits that have produced gross public debts of more than 200 percent of GDP. After his election in December 2012, prime minister Shinzo Abe decided to try and end this situation by adopting a new economic strategy ('Abenomics') involving three measures: fiscal expansion, monetary easing and growth-enhancing structural reforms.

The first two legs of the strategy were swiftly adopted. In January 2013 the new government adopted a fiscal stimulus of ¥10.3 trillion (€85 billion) equivalent to about two percent of GDP. And in April 2013 the Bank of Japan under the leadership of its new governor Haruhiko Kuroda announced the launch of quantitative and qualitative easing aimed at fulfilling the prime minister's goal of two percent inflation within two years.

The plan quickly changed the mood in Japan. The Nikkei 225 stock market index rose by more than 50 percent during the first five months after Shinzo Abe came to power. And although the stock market dipped in June 2013 it has fully recovered since. As a result of this positive economic sentiment, the prime minister easily won the mid-term Senate election in July 2013, enabling the adoption of bold structural reforms, the third leg of his strategy. Unfortunately the measures announced so far have been fairly modest.

One structural area in which the Abe government has moved rapidly is trade. In March 2013, it launched negotiations with the EU for a bilateral free trade agreement (FTA).

And in July 2013 Japan joined the US-led Trans-Pacific Partnership (TPP) initiative that seeks to create an FTA among countries of Asia, Australasia and the Americas.

The international community has been watching Abenomics with great interest. Although somewhat worried that the yen depreciated against other currencies by nearly 20 percent in the first five months after Mr. Abe came to power, it generally viewed positively the potential revival of the world's third largest economy. Thus, at their April 2013 Washington meeting, G20 finance ministers and central bank governors gave their approval to *"Japan's recent policy actions [that] are intended to stop deflation and support domestic demand"*.

In Europe, the reaction to Abenomics has also generally been positive. But concerns about the external value of the yen remain because the economic situation there remains worrisome, with GDP growth still fairly anemic. Both the hope of future Japanese accelerated growth and the apprehension about further yen depreciation are magnified by the prospect of more intense EU-Japan trade relations if and when the bilateral FTA is implemented.

2. The effects of Abenomics on Europe[1]

Japan's economic policies could have important economic repercussions for EU- Japan trade.

The International Monetary Fund (2013) attempted to analyse the effects of Abenomics on the rest of Asia on the assumption that Japan's new economic strategy produces higher GDP growth, a more depreciated currency and lower interest rates in Japan than otherwise. Effects on Asian partners would occur through two main channels: financial markets and trade.

According to the IMF, a successful exit from deflation and persistent yen depreciation could reduce the home bias of domestic Japanese investors and lead to a rebalancing of their portfolios to include a larger share of foreign assets, especially from Asia. Hence, the financial market effect of Abenomics on other Asian economies is likely to be positive.

At the same time, the IMF predicts that stronger growth in Japan would benefit exporters in other Asian countries, especially those supplying final goods to Japan. A

1. This section is partly based on Sapir (2013).

weaker yen has less straightforward implications. For countries that directly compete with Japan, this may undermine their competitiveness. However, this effect is mitigated by the fact that yen depreciation also raises production costs in Japan because of the higher costs of imported inputs. Likewise, many countries in Asia import intermediate goods from Japan, which become cheaper with yen depreciation, although possibly at the expense of domestic suppliers. Hence, the trade effect of yen depreciation is unlikely to be uniform across Asian countries and would depend on each country's position in the supply chain.

Stronger demand growth in Japan should also translate into higher exports for EU suppliers who would further benefit from the EU-Japan FTA when it is implemented. This could reverse the recent downward trend in the share of Japan as a *destination* of EU goods exports, which has fallen from 5.4 percent in 2001 to 3.3 percent in 2012. How much of this potential will be undermined by a weaker yen obviously depends partly on how much the yen depreciates against European currencies. The more it does, the more it would also boost Japan's exports, potentially to the detriment of EU production. A weaker yen could also reverse the strong downward trend in the share of Japan as a *supplier* of EU goods imports, which has dropped from 8.3 percent in 2001 to 3.6 percent in 2012.

Since the election of Mr. Abe as leader of his party and contender for the post of prime minister under the banner of Abenomics on 26 September 2012, the yen has depreciated by more than 30 percent against the dollar and by more than 40 percent against the euro. On 17 January 2014 it stood at ¥104 against the dollar and at ¥141 against the euro, compared to, respectively, ¥78 and ¥100 on 26 September 2012.

Will the fall of the yen continue?

Japanese analysts generally regard the current yen level as 'fair', but consider further depreciation problematic. For instance, Kazumasa Iwata, a former Bank of Japan deputy governor who is now president of the Japan Centre for Economic Research, has indicated that he *"believes the yen is fairly valued at ¥100 to the dollar, but that further weakness would represent a market 'overreaction' and 'could cause problems' for Japan's economy"* (Ross *et al*, 2013). Similarly, Koji Sakuma, General Manager and Chief Economist at the Institute for International Monetary Affairs, wrote in 2013 that *"the current level at around ¥95 against the US dollar is more or less a fair level. In this regard, the recent depreciation can be regarded as an adjustment of the overvaluation which emerged under the extreme strain of the global financial market after the Lehman shock and can be justified theoretically and internationally, therefore.*

However, excessive depreciation beyond this might annoy other nations and even be harmful to the Japanese economy" (Sakuma, 2013).

The IMF initially indicated that the lower yen level was 'appropriate', but later warned that it has become *"moderately below what would be consistent with medium-term norms"*. And with currency strategists predicting a yen soon falling to 110 against the dollar, international dissatisfaction may be brewing. Two developments point in this direction.

First, the US Treasury has on several occasions warned that it is *"closely monitoring"* Japan's economic policies to ensure that it *"refrain[s] from competitive devaluation and targeting its exchange rate for competitive purposes"* (US Treasury, 2013). And while it is true that the US Federal Reserve has engaged in monetary policies similar to the Bank of Japan's, their exchange rate effects seem to have been small. A study of the international effects of unconventional US monetary policy such as 'Operation Twist' (OT) by the IMF found that there was *"a significant, but generally short-lived, impact on bilateral exchange rates. OT, on the other hand, was accompanied by a sharp appreciation of the US dollar as 'flight to safety' by investors more than compensated for any depreciation effect from the Fed actions"* (IMF, 2012). A similar effect is unlikely in the case of the yen. On the other hand, the Japanese authorities are well aware that further yen depreciation would endanger Japan's export competitiveness because of the rising cost of imports, which are largely invoiced in US dollars.

Second, in May 2013 the Bank of Korea unexpectedly cut interest rates, citing the damaging effect that the weaker yen is having on its exports[2] If this move were followed by a significant depreciation of the Korean won, and perhaps of other Asian currencies, like the Taiwanese dollar, it would likely raise concerns about 'Factory Asia' not only in 'Factory North America' but also in 'Factory Europe'[3] Depreciation of the Chinese yuan is, however, generally regarded as less likely, both because it could fuel financial instability in China and because of the fear of trade retaliation.

So far, there has been little official (or otherwise) reaction in Europe to Abenomics and its consequences, except to say, as European Central Bank President Mario Draghi did

2. The same week, New Zealand's central bank admitted intervening in the currency market to try to weaken its dollar, which has come under pressure in part because of the weaker yen. Moreover, Australia cut interest rates, having previously warned that its exchange rate was too strong.
3. Factory Asia, Factory Europe and Factory North America are the three regional supply chains, that dominate global production and trade organised around, respectively, Japan (but also increasingly Korea and China), Germany (and other large EU countries) and the US. See Baldwin and Lopez-Gonzalez (2013).

in April 2013, that Japan's policy of monetary easing is *"determined by domestic policy considerations"* and that *"there is no currency war".* In part this is due to the fact that in 2012 Japan only accounted for 3.6 percent of EU merchandise imports and 3.3 percent of EU exports (compared to, respectively, 9.3 percent and 5.4 percent in 2000)[4] As a result, despite an appreciation of the euro against the yen of nearly 30 percent between September 2012 and April 2013, the Bank for International Settlement (BIS) estimated that the nominal effective exchange rate of the euro had 'only' appreciated by 4.8 percent thanks to the euro's depreciation against, *inter alia*, the US dollar, the Chinese yuan and the Korean won. However, between April and December 2013, the euro further appreciated not only against the yen but also on a multilateral basis. Thus, by December 2013 the euro had appreciated by 40 percent against the yen compared to September 2012 and by 10.9 percent on a nominal effective basis. These developments clearly add to the problems of the euro area and in particular of its peripheral members, which are struggling with high debt levels and low competitiveness.

3. Conclusion

Europeans are watching Abenomics with a mix of hope and apprehension. The hope is that the economic strategy will succeed in reviving the Japanese economy. This would obviously be desirable for the global economy in general and for Europe in particular, where growth has been dismal for a while. At the same time, there is some apprehension that the yen, which has depreciated against the euro by about 40 percent since September 2012, will continue to fall, unleashing declines of other Asian currencies against the euro. An important open question concerns the impact of the yen-euro exchange rate on the EU-Japan FTA negotiation. A further depreciation of the yen would risk raising worries in Europe that the envisaged deal is too favourable for Japan and could therefore be opposed or even blocked by import-competing European producers. Yet Japan's improved competitiveness might in fact impact Korean exports to the EU, which now enjoy free access thanks to the EU-Korea FTA, more strongly that it will impact European producers.

4. The figures are obviously much higher for Factory Asia, with China, Japan and Korea together accounting for 21.9 percent of EU imports and 14 percent of EU exports.

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East Asia's economic integration: progress made and implications for EU-Japan cooperation

TAKUJI KINKYO

While the bilateral relationship between the European Union and Japan continues to be important, the scope of EU-Japan cooperation needs to be broadened in the context of East Asia's economic integration. Intra-regional economic integration has been a key driving force for East Asia's rapid industrialisation and growth, from which both the EU and Japan have benefited a great deal. The European Union and Japan should collaborate to further promote trade and financial integration in East Asia.

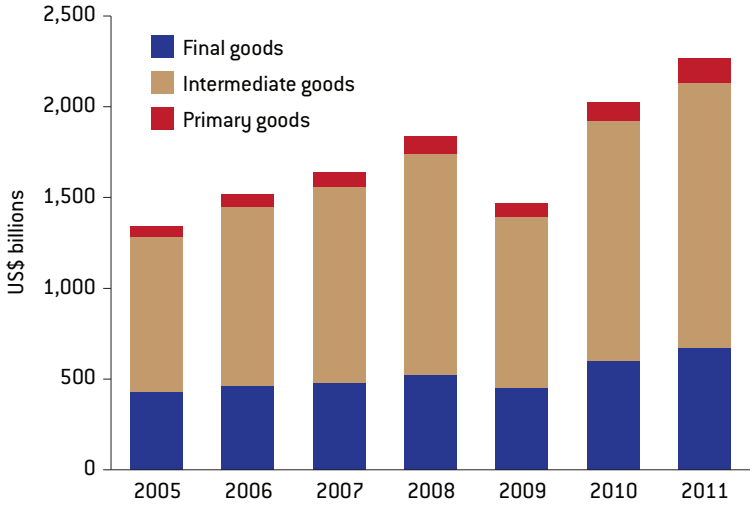
This chapter briefly summarises of the progress of economic integration in East Asia and discusses how EU-Japan cooperation can contribute to promoting further integration. Sections 1 and 2, respectively, examine the current state of trade and financial integration in East Asia and consider the policy implications. Section 3 reviews the progress of East Asia's regional financial safety net and discusses what Asia can learn from the recent European economic crisis. Section 4 concludes.

1. Trade integration in East Asia

1.1 Supply chains and intra-regional trade

East Asia, which includes greater China (mainland China, Hong Kong and Taiwan), Japan, Korea and the Association of Southeast Asian Nations (ASEAN), has recently witnessed a rapid increase in intra-regional trade. A notable feature of the area's intra-regional trade is a high proportion of intermediate goods, such as parts and components (Figure 1).

Figure 1: Intra-regional trade in East Asia



Source: RIETI-Japan, *RIETI–TID 2012*, http://www.rieti.go.jp.

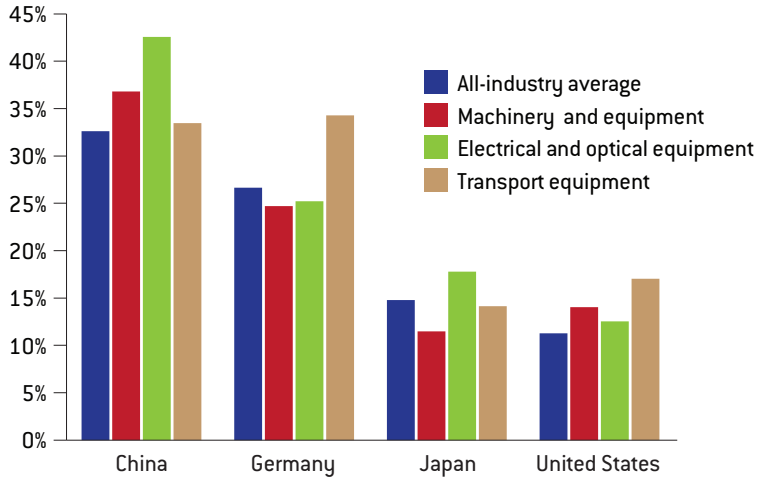
The large share of intermediate goods reflects the spread of vertically-integrated supply chains within the region (Ando and Kimura, 2005; Fukao *et al*, 2003). Behind this regional trend, there is a more global phenomenon of what has been called *"globalisation's second unbundling"* (Baldwin, 2006). The information and communication technology (ICT) revolution has enabled the production process to be decomposed into smaller sub-processes and has allowed each sub-process to be located in the most cost-effective country.

Regional supply chains are more extensive in East Asia than in other regions because of favourable trade- and investment-related policies, large inter-country wage differentials and efficient logistics (Gill and Kharas, 2007). Developing Asian economies have been able to speed up the process of industrialisation by joining regional supply chains, which provide a better opportunity to exploit comparative advantages and economies of scale. In this important way, regional economic integration and economic development are closely interrelated in East Asia.

China has been deeply engaged in Asia's supply chains and has successfully established itself as an assembly hub. In tandem, Japan, Korea and Taiwan have become major suppliers of high-quality intermediate goods to China. Figure 2 shows the decomposition of gross exports by value-added sources. The share of foreign

value-added in China's exports is high in comparison with other major exporters of manufactured goods. China has also served as an export platform for multinational enterprises. The local subsidiaries of multinational enterprises have contributed a great deal to China's exports. More than half of China's exports and imports are accounted for by foreign investors (Figure 3). Therefore, China can be characterised as a gateway for the exports of Factory Asia.

Figure 2: The share of foreign value-added in gross exports, selected countries



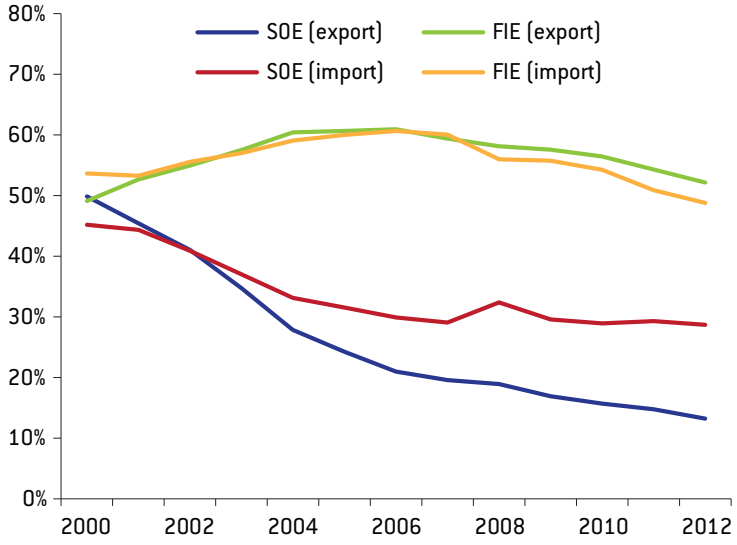
Source: OECD-WTO Trade in Value Added (TiVA) 2013.

It should, however, be emphasised that East Asia is by no means a self-contained economy. East Asia's exports of final goods are heavily dependent on extra-regional markets, notably Europe and the United States. As Figure 4 shows, the market share of extra-regions is much higher in the export of final goods than in the export of intermediate and primary goods.

The importance of extra-regional demand is more pronounced when exports are measured in value-added terms[5]. Table 1 shows the market share of Asia's exports both in gross and value-added terms. The share of extra-regions, particularly the EU and US, is significantly greater in value-added exports than in gross exports in major East

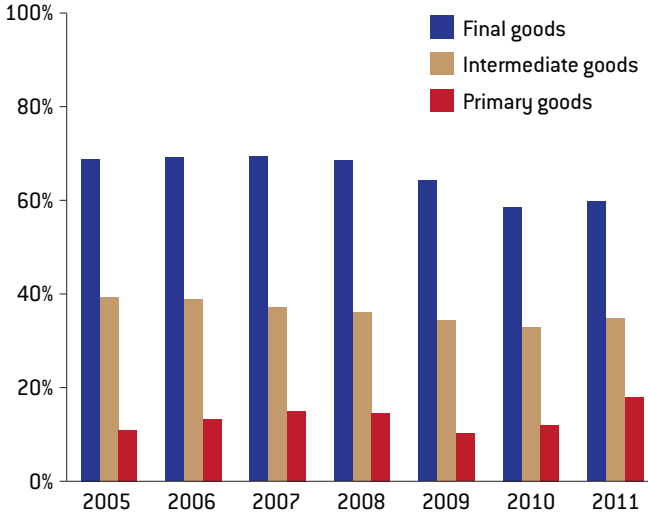
5. This measures the value added by each industry and country in the production chain, and allocates the value added to these source industries and countries. It recognises that growing global supply chains mean that a country's exports increasingly rely on intermediate imports. The data is available for more than 40 countries from 1995 to 2009. For more details, visit the OECD's website (www.oecd.org/sti/ind/whatistradeinvalueadded.htm).

Figure 3: China's export/import shares by type of enterprise



Source: CEIC Database. Note: SOE = state-owned enterprise, FIE: foreign investment enterprise.

Figure 4: The market share of extra-regions in East Asia's exports



Source: RIETI-Japan, *RIETI–TID 2012*, http://www.rieti.go.jp.

Asian economies. One possible explanation for this difference is that high-quality products are mainly sold in extra-regional economies that have greater purchasing power. Therefore, Asian economies rely more heavily on extra-regional demand for GDP growth and job creation than is indicated by gross exports. A key policy implication of this finding is that foreign trade agreements (FTAs) with extra-regions, particularly with the EU and the United States, are important to Asia to enhance its export competitiveness and thus maintain export-led growth.

Table 1: Market share of exports in gross and value-added terms

		(%)					
		East Asia	Japan	China	Extra-Regions	EU15	US
Gross Trade	Japan	46.6	–	20.3	53.4	13.2	16.6
	Korea	47.0	6.1	28.3	53.0	9.7	12.1
	China	24.1	8.7	–	75.9	20.7	22.6
	ASEAN6	30.5	8.6	14.1	69.5	13.9	12.7
Value-Added	Japan	32.2	–	14.0	67.8	16.9	21.3
Trade	Korea	29.8	7.1	14.9	70.2	15.0	19.4
	China	18.8	8.5	–	81.2	22.3	24.0
	ASEAN6	24.3	10.2	9.2	75.7	16.5	16.6

Source: OECD-WTO *Trade in Value Added (TiVA) 2013*. Note: 1. Data for 2009; 2. ASEAN+6: Indonesia, Malaysia, Philippines, Singapore, Thailand, Vietnam; 3. EU15: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom.

1.2 Asia's FTAs: benefits and challenges

Over the past two decades, there has been a rapid proliferation of FTAs across the world presumably as a result of slow progress in multilateral trade negotiations. Although East Asia previously lagged behind the global trend, the number of Asian FTAs began to increase in the 2000s. Currently, there are more than 70 FTAs in the region, with more to be agreed in the near future.

An FTA will have a positive trade-creation effect on its member countries. However, an FTA could also have an adverse trade-diversion effect on non-FTA member countries. Concerns about the latter will increase pressure on non-FTA member countries to participate in FTAs, facilitating the spread of FTAs among countries with close trade linkages. Solis *et al* (2009) argue that such a 'domino effect' was one of the key driving forces behind the rapid spread of FTAs across the Asia-Pacific region.

FTAs can contribute to the further expansion of Asia's supply chains by reducing both cross-border impediments and non-border regulatory barriers for trade and investment. However, despite the huge potential of FTAs in the region, East Asia fails to fully exploit the benefits of FTAs because of various problems.

First, the coverage of products differs significantly across Asia's FTAs (see Table 2). In particular, the coverage of agriculture is low in some of the FTAs because of political and economic concerns over the impact of free trade on domestic sectors. According to Kawai and Wignaraja (2013), 46 percent of the sampled FTAs in Asia have comprehensive coverage of agricultural products, 28 percent have some coverage, and 26 percent have little or no coverage[6]. Given the reciprocal nature of FTAs, the exclusion of agricultural products is likely to limit the scope of trade liberalisation of other products.

Table 2: The coverage of products in Asia's FTAs

		(%)
Japan (JP)	JP-Singapore	75
	JP-Philippines	69
	JP-ASEAN	69
	JP-India	69
China (CN)	CN-ASEAN	81
	CN-Taiwan	38
Korea (KR)	KR-ASEAN	56
	KR-Singapore	81
	KR-EU	88
	KR-USA	100
Singapore (SG)	SG-EFTA	81
	SG-US	56
	Traspacific Strategic EPA	75
ASEAN	AFTA	44

Source: Kawai and Wignaraja (2013)

Second, there is a great deal of room for promoting service-trade liberalisation. Although trade in services is expanding rapidly, there are varying degrees of

6. Comprehensive coverage means that at least 85 percent of agricultural products are covered or that no more than 150 products are excluded from an FTA. Some coverage means that more than 100 products are included but less than 85 percent of products are covered. Little or no coverage means that fewer than 100 products are included.

restrictions on services in different Asian countries in terms of the coverage of sectors and the severity of restrictions. The coverage of services also varies considerably in different Asian FTAs. Kawai and Wignaraja (2013) select five key service sectors, namely, business and professional services, communications services, financial services, transport services and labour mobility/entry of business persons, in order to assess their coverage by Asian FTAs. They find that 45 percent of the FTAs cover all five sectors, 23 percent cover two to four sectors, and 32 percent cover one sector or none. Although the majority of Asian FTAs have some coverage of services, the extent of liberalisation differs significantly among them.

Services liberalisation will not only facilitate trade in services *per se* but will also reduce the cost of service links, such as communication and transportation links that connect dispersed sub-processes in the supply chains. Golub, Jones, and Kierzkow (2007) provide evidence that successful manufacturing exporters, notably in East Asia, have favourable service links. It should also be noted that the development of modern service sectors, such as the ICT and financial sectors, is important for middle-income countries to sustain economic development and thereby avoid the 'middle-income trap'[7].

Finally, the presence of complex and inconsistent rules of origin (ROOs) in Asian FTAs can deter inter-FTA trade, which is a phenomenon known as the 'spaghetti-bowl' effect (Bhagwati, 1995). Some authors have argued that the spaghetti-bowl effect is a serious problem in Asia because the ROOs of Asian FTAs are overly restrictive and inconsistent (Manchin and Pelkmans-Balaoing, 2007; Tumbarello, 2007). However, Kawai and Wignaraja (2013), interpreting the data from the firm-level survey, argue that the existence of multiple ROOs could be a future problem, but has not yet become a problem. Moreover, Medalla (2011) finds that there is a substantial degree of commonality in the ROOs of five ASEAN+1 FTAs, though considerable variations still exist among these FTAs[8]. These results indicate that the benefit of Asia's FTAs can be increased by rationalising and harmonising the ROOs.

7. The middle-income trap is a phenomenon of middle-income countries, which struggle to maintain their rapid growth and therefore fail to graduate into the ranks of high-income countries (Gill and Kharas, 2007, pp17-18).
8. Five ASEAN+1 FTAs include ASEAN-Australia-New Zealand FTA, ASEAN-China FTA, ASEAN-India FTA, ASEAN-Japan FTA and ASEAN-Korea FTA.

1.3 The catalyst role of the EU-Japan FTA

In addition to the problems discussed above, Asia's FTAs have a major drawback related to their geographical coverage. As Table 3 shows, major intra-regional FTAs have evolved around ASEAN. In contrast, there is no FTA between China, Korea and Japan, though these three countries eventually launched negotiations for a tripartite FTA in November 2012. A region-wide FTA that covers all major economies will increase total welfare gains. In particular, trade and investment liberalisation will facilitate the spread of supply chains and therefore contribute to enhancing the productivity of Factory Asia.

Table 3: FTAs in Greater Asia

	Japan	China	Korea	ASEAN	India	Australia	New Zealand
Japan		△	○*	◎	◎	○	×
China	△		○	◎	△	○	◎
Korea	○*	○		◎	◎	○	○
ASEAN	◎	◎	◎		◎	◎	
India	◎	△	◎	◎		△	△
Australia	○	○	○	◎	△		○
New Zealand	×	◎	○		△	◎	

Source: Kawai and Wignaraja (2013), Ministry of Foreign Affairs, Japan. Note: ◎ effective/signed; ○ under negotiation; △ under feasibility study; × = no official action. * JP-KR negotiation is suspended. JP, CN and KR launched negotiations in November 2012.

Recognising the importance of a region-wide FTA, greater Asian countries, including India, Australia and New Zealand, launched negotiations for an FTA called the Regional Comprehensive Economic Partnership (RCEP) in November 2012. The RCEP aims to reach an agreement in three areas: trade liberalisation (reducing tariff and non-tariff barriers), trade facilitation (rationalising and harmonising ROOs, custom-clearance procedures, standards and regulations) and economic cooperation (supporting less advanced economies). According to the simulation analysis by the Comprehensive Economic Partnership in East Asia (CEPEA) Study Group (2009), the RCEP will significantly increase the GDP in all member countries if the full effect of trade liberalisation in combination with trade facilitation and economic cooperation is taken into account. Petri, Plummer and Zhai (2012) perform a more comprehensive simulation on the economic effect of the TPP and a region-wide Asian FTA. In their updated simulations (available at www.asiapacifictrade.org), they show that the RCEP will increase the total income of member countries by more than US$ 570 billion

(expressed in 2007 US dollars) per year in 2025. However, notwithstanding the potential benefits of the RCEP, major differences exist between China, Korea and Japan in terms of the scope and depth of liberalisation. Therefore, there is a serious risk of substantial compromise that will reduce the economic benefits of the RCEP.

Parallel to the RCEP, Japan has actively engaged in trade negotiations with extra-regional economies. Japan launched an FTA negotiation with the EU in March 2013, followed by participation in the Trans-Pacific Partnership (TPP) trade negotiation in July 2013. Such an omnidirectional approach to trade policy seems to reflect Japan's tradition of placing greater importance on multilateral trade liberalisation. It also seems to reflect the recognition that Factory Asia is highly dependent on the EU and the US for its exports.

From a strategic point of view, Japan can make use of the negotiations on the EU-Japan FTA and the TPP as a catalyst to facilitate RCEP negotiations. A successful conclusion on these high-quality FTAs might not only increase the pressure to accelerate the RCEP negotiations, but also sets a benchmark for the quality of the RCEP. Plummer (2007) illustrates the usefulness of identifying the FTA best practices and applying them to the assessment of FTA quality. The RCEP member countries can employ such a best-practices approach in setting a benchmark for their trade negotiations. The EU and Japan should make as much effort as possible to reach a high-quality trade agreement both in terms of scope and depth, which will provide a useful benchmark for the RCEP and other subsequent FTAs.

2. Financial integration in East Asia

2.1 Cross-border capital market integration

While East Asia's economic integration has been led by foreign trade and foreign direct investment, the region's economic integration through financial transactions, particularly portfolio investment, has lagged. When compared with Europe, the level of cross-border portfolio investment is much lower and its share of intra-regional flows in total investment is smaller in Asia (Pongsparn and Unterberdoerster, 2011).

The promotion of cross-border capital market integration through portfolio investment can increase the efficiency of the allocation of funds in various ways. Greater access to foreign capital markets will provide opportunities for domestic firms and governments to raise funds at lower costs. Likewise, cross-border access to financial products and services will allow domestic investors to diversify risks.

Capital market integration can also facilitate the development of domestic financial systems. Opening alternative channels for financial intermediation will expose domestic banks to competition, which will encourage banks to improve services and operational efficiency. In addition, greater foreign participation in domestic capital markets will lead to better price discovery and less price volatility by improving market liquidity and exerting pressure for better corporate governance (Prasad and Rajan, 2008). Furthermore, deep and liquid capital markets can serve as a fallback in the event of severe disruptions to the bank financing channel (Felman *et al*, 2011).

Table 4 shows the cross-border holdings of portfolio investment assets and liabilities relative to GDP. The data source is the IMF's Coordinated Portfolio Investment Survey. Because of differences in data coverage, only the liabilities of debt and equity securities are reported for China, Taiwan and Vietnam. The levels of debt securities are relatively low in Asian economies. In particular, the levels of debt assets are significantly below the average of G20 advanced economies. The exceptions are Hong Kong and Singapore, which serve as the region's major international financial centres. However, the levels of debt securities are also low in G20 non-East Asia emerging economies, indicating that inactive cross-border debt investment is not necessarily a unique feature to Asia.

Apart from Hong Kong and Singapore, the levels of equity assets are significantly lower on average in Asian economies than in advanced economies. By contrast, the levels of equity liabilities in Korea, Malaysia and Taiwan are as high as the average level in advanced economies. In G20 advanced economies, the cross-country average levels of debt assets and liabilities are higher than the levels of equity assets and liabilities. Conversely, the levels of equity assets and liabilities are generally higher than the levels of debt assets and liabilities in Asian economies.

In sum, the levels of cross-border portfolio investment are relatively low in emerging Asia apart from Hong Kong and Singapore. Although inward equity investment has been active in some Asian economies, debt investment generally remains relatively stagnant in both directions.

Why is Asia's cross-border capital market integration lagging? There are several potential impediments to Asia's cross-border investment, particularly bond investment. First, the bond markets in Asia are underdeveloped in terms of market size and liquidity. Although the bond markets have grown rapidly over the past decade, total bonds outstanding remain lower in most Asian economies than in advanced economies. The major exceptions are Korea and Malaysia, where compared to other

Table 4: Cross-border holdings of portfolio investment assets/liabilities

	(Ratio to GDP; %)			
	Bond securities		Equity securities	
	Assets	Liabilities	Assets	Liabilities
China	–	1.0	–	7.4
Hong Kong	153.6	10.0	260.2	132.9
Indonesia	0.8	6.0	0.1	8.4
Korea	3.0	14.6	8.5	25.6
Malaysia	4.6	21.6	10.5	22.8
Philippines	2.9	13.4	0.0	8.4
Singapore	91.9	18.2	87.2	59.1
Taiwan	–	3.1	–	43.2
Thailand	5.6	4.0	1.6	17.2
Vietnem	–	3.1	–	2.6
Average for				
G20 advanced economies	44.0	53.9	28.0	27.3
G20 non-East Asia emerging economies	1.3	6.2	5.4	12.7

Source: IMF *Coordinated Portfolio Investment Survey*. Note: 1. Data for 2010; 2. G20 advanced economies: Australia, Canada, France, Germany, Italy, Japan, UK, US; 3. G20 non-East Asia emerging economies: Argentina, Brazil, India, Mexico, Russia, Saudi Arabia, South Africa, Turkey.

Asian economies, bond markets are much larger and more diversified among government, corporate and financial institutions.

The lack of liquidity in local markets could also be a serious obstacle to cross-border investment. Asia's bond markets, particularly corporate bond markets are much less liquid than bond markets in advanced economies (Ghosh, 2006). Investors will be discouraged from investing in illiquid bond markets where price discovery is not functioning well and price volatility tends to be great. Market liquidity can be improved by establishing market makers, introducing modern trading platforms, and upgrading payments and settlement systems (Goswami and Sharma, 2011).

In a similar vein, broadening the base of domestic institutional investors, such as pension funds, insurance companies and mutual funds, is important to improve market liquidity. Although the asset size of domestic institutional investors remains relatively small, there is substantial scope for increasing the coverage of pensions and insurance in most emerging Asian countries (see Table 5). In addition, regulations on the investment of pension funds and insurance companies are generally conservative,

limiting the scope for diversifying investment allocations. Governments can promote the development of institutional investors by adopting international best practices for these regulations.

Table 5: Institutional investors in East Asia

	Life insurance premium volume to GDP (%)		Mutual fund assets to GDP (%)		Pension fund assets to GDP (%)	
	2007	2011	2007	2011	2007	2010
Japan	6.6	*7.1	16.4	12.7	23.8	23.7
Korea	7.7	7.2	31.4	20.3	3.9	3.9
China	1.7	2.1	12.4	4.6	–	0.7
Indonesia	1.1	*1.1	–	–	2.2	–
Malaysia	3.1	2.9	25.3	28.3	47.8	–
Philippines	1.1	0.9	1.4	1.1	–	3.5
Singapore	5.8	5.2	–	–	51.0	60.0
Thailand	2.3	3.1	18.8	–	5.2	5.7
Vietnam	0.8	0.6	0.3	–	–	–
United States	4.0	3.7	82.0	77.6	77.0	69.2

Source: World Bank *Global Financial Development*. Note: * Data for 2010.

The second potential impediment is the legal risk. There are significant legal risks in cross-border portfolio investment because of the information gap on regulatory frameworks, which differ across Asia in many respects. Therefore, it is important to increase transparency by improving access to local information on laws and regulations and on market practices. Effort should also be made to promote harmonisation in key regulations and practices through regional financial cooperation

Third, there is greater foreign exchange uncertainty that could discourage investment. Derivative markets, such as foreign exchange future, swaps and options, remain underdeveloped, and there are few effective instruments in most Asian economies to hedge foreign exchange risks. In addition, a majority of Asian economies maintain varying degrees of control over the international use of domestic currencies to prevent harmful speculative attacks. The development of derivative markets and the facilitated internationalisation of domestic currency are necessary to encourage cross-border portfolio investments.

Lastly, the presence of relatively stringent capital controls can be a major impediment.

Table 6 shows the index of capital controls on portfolio investment in major Asian economies[9]. Overall, the capital control is relatively stringent in Asian economies, except in Hong Kong, Korea and Singapore. Interestingly, controls on capital outflows are generally tighter than those on capital inflows in Asian economies presumably because of their greater concerns about capital flight. The removal of excessive capital controls could be a driving force for cross-border bond investment and further market integration in Asia.

Table 6: Capital flow index on portfolio investment

	Year	Inflows	Outflows		Year	Inflows	Outflows
China	1997	1.0	1.0	Malaysia	1997	0.5	1.0
	2000	1.0	1.0		2000	0.5	1.0
	2005	1.0	1.0		2005	0.5	1.0
Hong Kong	1997	0.0	0.0	Philippines	1997	0.5	1.0
	2000	0.0	0.0		2000	0.5	1.0
	2005	0.0	0.0		2005	1.0	1.0
Indonesia	1997	0.3	0.3	Singapore	1997	0.0	0.3
	2000	0.5	0.5		2000	0.0	0.5
	2005	0.5	0.5		2005	0.0	0.5
Korea	1997	0.8	0.3	Thailand	1997	0.8	1.0
	2000	0.0	0.5		2000	0.5	0.8
	2005	0.0	0.3		2005	0.8	1.0

Source: Schindler (2009). Note: The index is the average of the indices for equity and bond investment. The strictness of capital controls is measured by the scale between 0 and 1. A larger value of the index implies more stringent controls.

2.3 ASEAN capital market integration

Among policymakers in the ASEAN countries, there has been a shared recognition of the need to develop integrated regional capital markets. Capital markets in the ASEAN countries are individually small and illiquid: therefore, transaction costs are relatively

9. The index is constructed by Schindler (2009) using the information provided in the IMF's Annual Report Exchange Rate Arrangements and Restrictions.

high. Moreover, the varieties of products and services are limited and the investor base remains narrow. Greater access to foreign investors and issuers through market integration will increase the liquidity of domestic markets and broaden the range of products and services.

Against such a background, ASEAN finance ministers endorsed an Implementation Plan at their regular meeting in 2009[10]. The objective of the Implementation Plan was to promote the development of an integrated capital market, which is an integral part of the ASEAN Economic Community (AEC) Blueprint 2015. The AEC Blueprint 2015, which was agreed upon by ASEAN leaders in 2007, aims to establish ASEAN as a single market and production base, with a free flow of goods, services, investments and skilled workers, and a freer flow of capital. The Implementation Plan seeks to achieve the goal of freer capital flows by providing a comprehensive set of strategic initiatives and formulating specific implementation actions and milestones.

One of the important characteristics of the Implementation Plan was its gradual and phased approach to market integration[11]. Instead of setting an ambitious target of full convergence of regulations and standards, the Implementation Plan intends to create an enabling environment for cross-border access by promoting the mutual recognition and harmonisation of local regulations and standards. In addition, the Implementation Plan aims to facilitate the alliance of the ASEAN countries' stock exchanges to encourage cross-border trading of listed stocks. It also seeks to promote regionally focused products to build awareness of ASEAN as an asset class. Furthermore, efforts will be made to strengthen the implementation process by aligning domestic capital-market development plans to regional initiatives and by reinforcing the ASEAN-level working mechanism by setting up a coordination team inside the ASEAN secretariat.

Box 1 summarises the strategic components of the Implementation Plan. These measures will be undertaken in stages. For example, the mutual recognition framework will be initially established bilaterally between parties, and multilateral arrangements will be subsequently developed when countries with less-advanced capital markets

10. The Implementation Plan was drafted and proposed by the ASEAN Capital Market Forum, which is comprised of the heads of securities regulators in ASEAN member countries.
11. The Implementation Plan is guided by six key principles: (1) Adoption of international standards to the maximum extent possible; (2) Progressive liberalisation to facilitate more open access and cost reduction through greater competition; (3) Sequencing of regional integration initiatives taking into account the ease of implementation, market preferences and technical linkages; (4) Adequate coordination of the ASEAN-level working processes; (5) Consistent implementation of policies to support regional integration at the country level, with effective monitoring mechanisms; and (6) Strong communication planning and consultative processes to build consensus and set priorities for integration initiatives.

are ready to join. Likewise, cross-border access to foreign products and services will be made possible for non-retail investors and then retail investors when adequate investor protection measures are in place.

Such a step-by-step approach to market integration appears to be appropriate given the wide discrepancy in income levels and stage of financial development of ASEAN

BOX 1: STRATEGIC COMPONENTS OF THE IMPLEMENTATION PLAN

I. Mutual recognition framework to facilitate:

- Cross-border fund raising
- Product distribution
- Cross-border investments within ASEAN
- Market access by intermediaries

II. ASEAN exchange alliance and governance framework

- Build trading linkages and setup ASEAN Board
- Enhance governance, trading efficiency and cost reduction
- Clearing, depository and settlement linkage
- Marketing and investor education

III. Promote new products and build ASEAN as an asset class

- Promote private sector led regional products development
- Promote ASEAN star companies under the ASEAN board

IV. Strengthen bond markets

- Accelerate reform initiatives in bond issuance, listing and distribution
- Design a regional strategy for ratings comparability
- Improve market liquidity, and clearing & settlement of linkages

V. Align domestic CMDP to support regional integration

- Align national development initiatives to support cross border integration
- Adopt phased approach to liberalisation to ensure domestic market readiness

VI. Reinforce ASEAN working process

- Establish ASEAN Coordinating Team, comprising dedicated resources from ASEC and dedicated point persons from ACMF members to monitor, coordinate, report and raise issues on the Implementation Plan.

Source: *The Implementation Plan* endorsed at the ASEAN Finance Ministers Meeting in 2009.

countries. In particular, there are significant gaps in countries' regulatory capacity and market infrastructure. These gaps could be serious obstacles to the process of integration. It is therefore important to provide less-advanced countries with technical assistance that will support their efforts to build regulatory capacity and market infrastructures. The EU and Japan should collaborate to take a leading role in coordinating such assistance within the Asian region and in filling the gap in funding resources.

3. Regional financial safety net[12]

Emerging market economies are increasingly exposed to the risk of financial instability posed by the acceleration of financial globalisation. Following the Asian financial crisis of 1997-98, ASEAN and China, Japan and Korea (ASEAN+3) established a regional financial safety net known as the Chiang Mai Initiative (CMI). The core objective of the CMI was to create a network of bilateral swap agreements (BSAs) among the ASEAN+3 members, particularly between the plus-three countries and the ASEAN members. Through this arrangement, member countries could save the cost of balance-of-payments insurance by pooling part of their reserves instead of holding a large stock of foreign reserves.

Since it began, the CMI has made significant progress in expanding the size of pooled reserves and streamlining the decision-making procedure. Among a series of efforts to strengthen the capacity of the CMI, the CMI multilateralisation (CMIM) is the most significant. The CMIM, which came into effect in 2010, introduced a single contractual agreement to govern all of the BSAs. It would enhance the transparency of swap agreements and facilitate the prompt and simultaneous activation of swaps by establishing a collective decision-making procedure. The total fund size that can be mobilized through the activation of the swaps was increased substantially[13]. Compared with the previous CMI, the CMIM is a more inclusive arrangement because all of the ASEAN+3 members participate and financially contribute to it.

Despite the significant progress of the CMI, Asian countries have failed to save the cost of the balance-of-payments insurance by reducing their foreign reserves. In fact, since the Asian crisis, the pace of reserve accumulation has accelerated. It appears that the CMI is not yet perceived as a serious alternative to costly self-insurance through

12. The discussion in this section is based on Kinkyo (2013a, b).
13. The total fund size was increased to US$120 billion. In 2012, there was a new agreement to double the total fund size.

reserve accumulation. Furthermore, the CMI was not activated during the global financial crisis of 2007-09. Although the Korean authorities arranged for and activated a swap agreement with the US Federal Reserve during the crisis, they did not seek to activate the CMI.

Asian countries are reluctant to activate the CMI because of its explicit linkage to the International Monetary Fund programme. To fully activate the swap, a borrowing country needs to negotiate an IMF programme[14]. However, Asian countries have a deep distrust of IMF programmes because of their uncomfortable experience during the Asian financial crisis (Ito, 2007). Asia's antipathy towards the IMF is a major obstacle to the activation of the CMI.

In this respect, Europe's response to the recent economic crisis provides valuable lessons. The IMF was involved substantially in the bailout of crisis-affected countries, such as Greece, Ireland and Portugal. European countries took the initiative in crisis resolution through close coordination between the *Troika* of the European Commission, the European Central Bank (ECB), and the IMF[15].

Furthermore, the IMF works closely with the European Stability Mechanism (ESM), which was inaugurated in October 2012. The ESM is a permanent bailout fund established by a treaty signed by all the euro-area countries[16]. The ESM Board of Governors is authorised to make decisions on key issues, such as the approval of financial assistance. The board is comprised of the financial ministers of euro-area countries, with the European Commissioner for Economic and Monetary Affairs and the President of the ECB participating as observers. On behalf of the Board of Governors, the European Commission will work closely with the IMF to assess risks to financial stability, analyse the sustainability of debt, negotiate adjustment programmes and monitor programme compliance[17]. Therefore, although the IMF and ESM provide loans under different terms, their conditions and disbursement are closely coordinated (Pisani-Ferry *et al*, 2013).

14. A minor portion of the swap can be activated without the IMF programme. However, the remaining part requires an agreement or near-agreement with the IMF. The ceiling of the IMF non-linked portion was raised from 10 percent to 20 percent in 2005 and there was a new agreement to raise it to 30 percent in 2012.
15. See Pisani-Ferry *et al* (2013) for the detailed analysis of EU-IMF cooperation in resolving the European economic crisis.
16. For more details of the ESM, see European Central Bank (2011).
17. More specifically, a Memorandum of Understanding (MOU) that specifies the conditionality attached to the loan is negotiated by the European Commission in liaison with the ECB and the IMF, and debt stability analysis is jointly conducted by the Commission and the IMF. A euro-area member country requesting financial assistance from the ESM is expected to address, wherever possible, a similar request to the IMF (IMF, 2013, p.38).

The coordination between the CMI and the IMF should be strengthened to avoid duplication and to establish a more efficient division of labour. Specifically, Asia should consider establishing a regional financial arrangement modelled on the ESM, which will provide financial assistance in close collaboration with the IMF. Under the existing CMI framework, Asia delegates the adjustment programme negotiation to the IMF, and, as discussed above, the full activation of the swap is linked passively to the IMF programme. Currently, there is no institutional arrangement for the CMI member representatives to be involved in the design of the programme.

By contrast, an EMS-type arrangement envisages an adjustment programme negotiated in close collaboration with the IMF. Such an arrangement could become an alternative to costly reserve accumulation by establishing a well-designed co-ordination mechanism with the IMF, which would enhance Asia's ownership of adjustment programmes and reduce antipathy towards the IMF.

Another key lesson that Asia can learn from the European economic crisis is the importance of effective economic surveillance for crisis prevention. The crisis had its origins in the build-up of financial, fiscal and economic imbalances in the euro area (OECD, 2012). In particular, the widening of current-account imbalances rendered the euro-area countries vulnerable to financial contagion. The vulnerabilities were created because current-account imbalances were associated with unsustainable credit booms in the deficit countries, which were financed by cheap but volatile capital flows from the surplus countries. See Cline and Wolff (2012) for more detailed analysis of the causes of the European economic crisis.

The crisis could have been prevented if the sources of such imbalances had been identified through the surveillance, and necessary policy adjustments, such as the rebalancing of fiscal policy and tightening of macroprudential regulations, had been made. The need for effective surveillance should be even greater in Asia, which is more susceptible to asymmetric shocks because of the heterogeneity of the region's economies. After the Asian crisis, the ASEAN+3 countries introduced a regional surveillance mechanism known as the Economic Review and Policy Dialogue (EPRD). In 2011, the EPRD process was reinforced by the establishment of an independent surveillance unit (ASEAN+3 Macroeconomic Research Office: AMRO) in Singapore.

Asia should strengthen its cooperation with the IMF to enhance the effectiveness of regional economic surveillance. For example, AMRO officials should be allowed to participate in the IMF's Article IV consultation missions to the ASEAN+3 members. This is important to establish the foundation for closer collaboration in crisis resolution,

which is a prerequisite for the creation and successful operation of an ESM-type arrangement.

Moreover, the EU and Japan should work together to encourage AMRO and ESM to strengthen their operational cooperation. To begin with, AMRO and ESM can hold regular meetings to exchange views and share experience on surveillance and crisis management. A regular dialogue will help both institutions to identify best practices for their operations. Over the long run, the two institutions should consider developing an institutional framework for coordinating their crisis management operations. The recent global financial crisis has demonstrated that financial shocks can be transmitted rapidly across regions. With a greater risk of financial contagion, there is a growing need for strengthened cooperation between regional financial arrangements, and between regional and multilateral arrangements. AMRO and ESM can set a precedent for effective inter-regional cooperation on crisis management.

4. Conclusions

East Asia has recently witnessed a rapid increase in intra-regional trade, especially in intermediate goods. This reflects the spread of vertically-integrated supply chains within the region. An FTA can contribute to further trade integration in East Asia. In particular, a region-wide FTA, notably the RCEP, will facilitate the spread of regional supply chains and therefore enhance the productivity of Factory Asia.

By comparison, Asia's integration through cross-border financial transactions, particularly portfolio investment, is lagging. Although ASEAN member countries seek to promote the development of integrated capital markets, there are large inter-country gaps in the regulatory capacity and market infrastructures, hindering further integration.

East Asia's economic integration has been a key driving force for the region's rapid industrialisation and growth, from which both EU and Japan have greatly benefitted. To further promote trade and financial integration in East Asia, the EU and Japan should strengthen economic cooperation. More specifically, efforts should be made in the following areas.

- The EU and Japan should make as much effort as possible to reach a high-quality trade agreement both in terms of scope and depth, that provides a useful benchmark for the RCEP and other subsequent FTAs.

- The EU and Japan should collaborate to take a leading role in coordinating technical assistance for the ASEAN capital market development and in filling the gap in funding resources.

- The EU and Japan should work together to encourage AMRO and ESM to strengthen their cooperation on surveillance and crisis management operations.

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Trade and financial linkages between Europe and Japan: new evidence and scope for improvement

MICHAEL G. PLUMMER

Japan and the European Union face major challenges in the emerging international marketplace of the twenty-first century, but there are also significant opportunities. The EU and Japan have common priorities in the economic reform process, from structural reforms in agriculture and labour markets to debt reduction. The contributions from André Sapir and Takuji Kinkyo give an extensive review of EU-Japan trade and investment links, noting that the relationship continues to be strong, even though the shift in economic gravity towards Asia has had an important effect on trade and investment flows in favour of that part of the world, especially China. The rising role of regional production networks and value chains in driving economic integration is underscored in both contributions and is clear from the data analysis. Sapir and Kinkyo in their contributions make the case that strengthening the EU-Japan economic partnership should be an important policy priority to enhance competitiveness and facilitate structural adjustment, including formal modes of cooperation such as an EU-Japan free-trade area (FTA).

I would like to focus on the implications of the regionalism trend in the Asia-Pacific for both the EU and Japan, somewhat deepening the discussion on FTAs in Asia broached by the Kinkyo contribution. In particular, I consider the implications of the mega-regionalism movement in the Asia-Pacific region for Japan, the EU and the EU-Japan economic relationship.

Japan and mega-regionalism

The 'Asian noodle bowl' of criss-crossing FTAs in the Asia-Pacific region is well-known and is well-documented by the Kinkyo chapter. As he notes, while Asian regionalism is complicated, in large part it has been driven by the need to support regional production networks. However, bilateral FTAs will always fall short in supporting *regional* production networks. Hence, a regional approach to economic cooperation is particularly important in the Asian context.

The Trans-Pacific Partnership (TPP) in its current negotiating format began in 2008 and recently completed its twentieth round of negotiations. It has missed several deadlines to finish up and the current goal is to sign an accord during 2014, though this will be difficult for a variety of reasons, not least of which mid-term elections in the United States. The TPP is being designed as a 'twenty-first century' FTA and would include: (1) elimination of most tariffs and non-tariff barriers; (2) new trade issues such as those created by electronic commerce, the fragmentation of production in modern supply chains and the rise of state-owned enterprises; (3) reaching behind the border to make regulations more transparent and easier to navigate, including by smaller enterprises. The Regional Comprehensive Economic Partnership (RCEP) is a much more recent initiative; it was established in November 2012 and held its third round of negotiations in January 2014. While it is not yet clear how comprehensive RCEP will be, it will include many of the chapters that are being tackled in the TPP but will allow for more 'flexibility', particularly in terms of special and preferential treatment for lower-income economies.

Japan is an active participant in the emerging mega-regionalism movement in the Asia-Pacific. Japan is the latest party to join the TPP negotiations (July 2013) but is a founding member of RCEP. In the modelling work that I have done with my colleagues Peter Petri and Fan Zhai[18], we use a Computable General Equilibrium (CGE) model to estimate the potential effects of the TPP and RCEP tracks on economic welfare, exports and structural change of Japan, other participating countries and non-members. The gains to Japan are large (Table 1): by 2025 we estimate that the TPP and RCEP will generate gains of $105 billion and $96 billion, respectively, or approximately two percent of Japanese GDP, relative to the baseline. The reasons for these gains include the fact that, if the TPP indeed becomes the high quality accord that it is purported to be, it will enable Japan to attract new foreign investment and to increase exports by 11 percent, with an emphasis on sophisticated manufactured products and services. It would increase Japanese productivity, especially in services. Even in agriculture, it

18. See, for example, Petri *et al* (2012) and more recent simulations at our website, www.asiapacifictrade.org .

would open up new opportunities in both domestic and foreign markets. The same story generally holds for RCEP.

Table 1: Welfare effects of the TPP and RCEP

	2025 Baseline	2025 Change from baseline: (US$b)			Percent		
	GDP	TPP12	FTAAP	RCEP	TPP12	FTAAP	RCEP
Americas	**24,867**	**101.7**	**452.3**	**2.5**	**0.4**	**1.8**	**0.0**
United States	20,273	76.6	328.2	-0.1	0.4	1.6	0.0
Asia	**34,901**	**125.2**	**1653.4**	**627.0**	**0.4**	**4.7**	**1.8**
China	17,249	-34.8	837.1	249.7	-0.2	4.9	1.4
Japan	5,338	104.6	233.1	95.8	2.0	4.4	1.8
Others	**41,820**	**-14.1**	**213.4**	**-6.8**	**0.0**	**0.5**	**0.0**
Europe	22,714	-3.7	-40.9	5.1	0.0	-0.2	0.0
WORLD	**103,223**	**223.4**	**2358.5**	**644.4**	**0.2**	**2.3**	**0.6**
Memorandum							
TPP12	33,045	285.0	878.6	155.1	0.9	2.7	0.5
RCEP	35,290	137.4	1490.2	617.9	0.4	4.2	1.8

Source: Petri, Plummer and Zhai (www.asiapacifictrade.org).

Moreover, should the RCEP and TPP merge into a 'Free-Trade Area of the Asia-Pacific' (FTAAP), which is the ambitious trade-related goal of the Asia-Pacific Economic Cooperation (APEC) organisation, Japan's welfare gains would increase to $233 billion (four percent of GDP), only somewhat more than the combined effects of RCEP and TPP separately. Hence, in Asia-Pacific cooperation, Japan would get the large majority of its gains via the two tracks in which it is currently engaged.

Japan's membership of the TPP will have positive global effects too. The expansion of the TPP highlights a remarkable competitive process: the agreement started with only four small countries (Brunei, Chile, New Zealand and Singapore) but has since grown to eight, nine, eleven and now 12 countries, with South Korea already in preliminary negotiations about possibly joining and the Philippines, Thailand and Indonesia suggesting possible membership in the future. Moreover, the TPP has likely prodded not only the RCEP but also the proposed EU-Japan accord and the EU-US Trans-Pacific Trade and Investment Partnership (TTIP).

Of course, the above gains accrue from structural change in favour of efficiency, and inefficient sectors in Japan will contract to some extent. Agriculture is the greatest

concern in Japan, because of its political sensitivity. Still, agriculture is now just one percent of the Japanese economy, and frankly, the degree to which it would contract is often exaggerated. Further, studies by the Organisation for Economic Cooperation and Development, as well as our results, show many opportunities for competitive agriculture, in high-value fruits and vegetables, organic products, tourism and so on. We also anticipate that Japan will be able to keep some of its most sensitive barriers and, in the end, project only mild, gradual declines for the agriculture sector as a whole. The large benefits elsewhere in the economy would allow generous compensation for people who might be harmed in this transition.

So Japan might envision the TPP to embrace a broad strategy that also supports RCEP and trade negotiations with China, Korea and the EU. Ideally, Japan will promote similar, high quality rules in all negotiations, helping to build a consistent, rules-based trading system.

Implications for the EU

The effects of mega-regionalism in the Asia-Pacific will likely be small for the EU, in large part because the process will be 'open' and the participating countries already have relatively low trade barriers, leaving less potential for trade and investment diversion. Indeed, our estimates suggest that the EU will only bear a $4 billion trade diversion effect from the TPP and actually a net gain from RCEP, due to growth and terms-of-trade effects. An FTAAP would create a large trade diversion effect of $41 billion, four times that of the TPP but only two-tenths of one percent of EU GDP. Moreover, EU members would gain from a more stable and prosperous Asian region, where approximately two-thirds of the world's poor live.

Still, we would suggest that EU does have a strong incentive to link with this movement for a number of reasons[19]. First, while trade diversion in the aggregate will be small, the effects could be substantial at the product level (Plummer 2014). Second, the standards being established especially in the context of the TPP could become global standards; in fact, it would seem that this is a salient goal of the negotiators. It would be in the EU's strategic interest to be a participant in these discussions. For example, the EU was actively involved in crafting the Anti-Counterfeiting Trade Agreement (ACTA) but as it was vetoed by the European Parliament in 2012, the intellectual-property chapter of the TPP could well emerge as the industry standard. In addition, in the context of mega-regionalism, EU firms active in Asia will be able to profit from enhanced

19. See Plummer (2014).

efficiencies, and new exports markets can be exploited. But the gains would certainly not be as great as they would if the EU was involved in the process; the EU would gain more from liberalisation at the multilateral level. The EU can (and is) negotiating accords with major participants in these processes, but these are generally bilateral accords; some of the biggest gains from the Asian and Transpacific tracks derive from the ability of these regions to consolidate their many bilateral FTAs, thereby reducing the costs associated with rules of origin and increasing utilisation rates of commercial preferences inherent in the accords. The EU will not be able to do this, unless, of course, it pushed for an initiative at the Asia-Europe Meeting (ASEM), but that would take a sea-change in the direction of that organisation. Moreover, the Asia-Pacific region is the largest and most dynamic region in the world: remaining outside the integration process will be costly not only in terms of potential economic discrimination but also its ability to guide global commercial policy.

Concluding remarks

The chapters by André Sapir and Takuji Kinkyo make strong implicit and explicit cases for an EU-Japan FTA; our analysis suggests that the EU has a strong interest in the process of regional economic integration in the Asia-Pacific region and would do well to connect with it to the greatest extent possible. An EU-Japan FTA (as well as the TTIP) would be an important step in this direction.

However, it is important to note that mega-regionalism needs to be well-nested in the World Trade Organisation context and directed in such a way that it supports global rules and integration rather than regional ones. The EU and Japan, as well as the United States and the rest of the global community, should keep this in mind as they negotiate these mega-agreements.

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Part 2:

Housing bubbles, government responses and economic/corporate adjustments: can Europe learn from Japan?

Japanification or salvation

JOACHIM FELS

Isn't it ironic? Just as Japan, thanks to aggressive monetary and fiscal policies, is about to exit deflation at long last, the euro area risks falling into a deflationary trap similar to that which Japan experienced in the 1990s and 2000s. Back then, Japan suffered from a prolonged post-bubble balance sheet recession, a late and overly cautious monetary policy response, periodic strong currency appreciation, a failure to enforce a rapid clean-up of bank balance sheets, a premature fiscal tightening in 1997 that pushed the economy back into recession and a general institutional reform sclerosis. Sounds familiar?

Of course, the euro area is not Japan and history doesn't repeat itself. But there are echoes, and given the many parallels, a Japanification of the euro area is a serious risk. I believe that Japanification can still be avoided if euro-area policymakers heed three lessons from Japan: i) Monetary policy should move early and aggressively before deflation manifests itself; ii) Regulators should enforce a clean-up of bank balance sheets, including a realistic assessment of bad assets and swift recapitalisation where needed; and iii) Governments should avoid overly tight fiscal policies that could plunge economies back into recession.

The Japan narrative

The story of Japan's two lost decades has been told many times, so it suffices to recap the key elements briefly.

The prelude to the lost decades was the three Bs: a boom that begot a bubble that ended in a bust. Easy monetary policy and strong growth in the second half of the 1980s fuelled a debt-financed equity- and land-price bubble, which burst in the early 1990s after the Bank of Japan tightened policy sharply.

What followed can be summarised as the three Ds: deleveraging, deflation and debt. The collapse in equity and land prices pushed many firms and households into negative equity and induced them to pay down debt.

- Deleveraging depressed demand, resulting in what Richard Koo has called a balance-sheet recession. A series of fiscal stimulus packages by the government helped to mitigate the impact of private-sector balance-sheet contraction on demand, making the recession more shallow and even supporting occasional recoveries.

- Deflation set in only several years after the bubble burst. In my view, it largely resulted from a combination of delayed balance-sheet clean-up in the banking sector and a slow response by the Bank of Japan to the balance-sheet recession in the first half of the 1990s, which was partly explained by the fear of pumping up yet another bubble. By the time the Bank of Japan finally cut official rates to the zero bound (1998), deflation had already set in so that real interest rates never went negative.

- Public sector debt rose sharply, partly as a consequence of the many fiscal stimulus packages, and partly as a consequence of deflation, which resulted in falling nominal incomes and tax receipts.

Finally, another important element of the Japan narrative is the CRIC cycle – the cycle of crisis, response, improvement and complacency – which my colleague Robert Feldman coined and described as early as 2001 to explain Japan's institutional reform sclerosis. The cycle arises from the interaction of two natural tendencies: i) The economy responds slowly to policy reforms; and ii) Policymakers tend to slow the reform process as the economy improves. Each economic crisis during the lost decades sparked a policy response, but the subsequent economic and market improvements led to complacency on the part of policymakers, which in turn paved the way for the next crisis.

How Japanese is the euro area?

The Japan narrative is certainly not a blueprint for the euro area. There are some important differences, but there are also many parallels. Here is my list of the main similarities and differences:

- Like in Japan, a cycle of boom, bubble and bust was at the origin of the euro area's

current problems. A sharp decline in real interest rates and strong growth in the peripheral countries following the introduction of the euro led to debt-financed asset price booms and bubbles, which eventually burst in the late 2000s.

- Yet, much of the booms and bubbles in the periphery was financed by lenders from the core, who quickly withdrew their capital when the bubble burst. Thus, the bursting asset bubble and the resulting banking sector problems turned into an intra-euro area balance-of-payments crisis, which led to doubts about the viability of the single currency. In this sense, the euro-area crisis was much worse than the Japanese crisis.

- In addition, markets soon realised that the euro-area member states were not true sovereigns as they were indebted in a currency they could not print themselves. Thus, markets refused to fund governments at reasonable interest rates and a sovereign debt crisis resulted. Therefore, contrary to Japan, the euro-area countries most affected by the crisis lost their ability to pursue countercyclical fiscal policies and instead had to tighten policy into the downturn, thus aggravating the recession. By contrast, Japan was able to mitigate the consequences of the balance-sheet recession in the private sector through expansionary fiscal policy. And when the government decided to raise the consumption tax in 1997 after an economic recovery in 1995-96, it soon turned out to be a mistake because it pushed the economy back into recession.

- Another important parallel between Japan back then and the euro area today is the slow progress made in cleaning up bank balance sheets and recapitalising financial institutions. As a consequence, both Japan and the euro area witnessed (and the latter is still witnessing) a contraction of credit volumes and weak broad money growth. The European Central Bank's master plan is to achieve the balance sheet clean-up and recapitalisation in the run-up to banking union. If successful, this could be an important catalyst for repairing the credit mechanism. Yet, much work remains to be done, and in the meantime, bank deleveraging with its potentially deflationary consequences will likely continue.

- Until recently, the ECB was able to prevent deflation and keep inflation expectations anchored around its definition of price stability (below but close to 2 percent). Arguably, this has been due to the fairly aggressive early response since the onset of the crisis in 2007-08, when the ECB started to engage in various forms of unconventional easing. However, note that deflation only took hold in Japan about eight years into the balance-sheet recession – thus it is too early for the euro area

to rejoice, in my view. The risk of deflation in the euro area has increased recently. Why? First, credit keeps contracting as bank deleveraging continues or even accelerates ahead of 2014's asset quality review and stress test. Second, wages in several crisis countries such as Spain are now starting to fall as a lagged consequence of high unemployment and past labour-market reforms. Third, the euro has appreciated further in response to the Fed's change-of-mind on tapering. Meanwhile, current inflation is already running significantly below target and looks set to drop further this month. But so far, the ECB has stubbornly refused to acknowledge deflationary risks, much like the Bank of Japan before the onset of Japan's deflation.

Japanification can still be avoided

Taken together, a Japanification of the euro area is a serious risk. But I believe that Japanification can still be avoided if euro-area policymakers heed three lessons from Japan: i) Monetary policy should move early and aggressively before deflation manifests itself; ii) Regulators should enforce a clean-up of bank balance sheets including a realistic assessment of bad assets and a swift recapitalisation where needed; and iii) Governments should avoid overly tight fiscal policies that could plunge economies back into recession. I think there is a better-than-even chance that these lessons will be heeded and the euro area's Japanification can be avoided. But I'm nervous.

Land price bubbles, government responses and economic/corporate adjustment in Japan

TOMOMI MIYAZAKI

1. Introduction

Japan has experienced the long stagnation of the so-called 'lost two decades' since the early 1990s. Although some economic indicators show signs of recovery, it seems not to be a full-fledged recovery from Japan's long recession. Japan's long stagnation was attributed to policy failures from the late 1980s to the early 1990s that fueled the so-called 'bubble' economy. Asset prices rose drastically in the late1980s. However, as many previous studies such as Okina *et al* (2001), Okina and Shiratsuka (2002) and Asako (2012) argue, the sharp rise in asset prices was a bubble that did not necessarily reflect market fundamentals. Needless to say, bubble cannot persist indefinitely. In the early 1990s, asset prices were falling. As a result, the Japanese economy was depressed. To stimulate the economy, the Bank of Japan and the Japanese government followed expansionary monetary and fiscal policies. The Japanese government put in place large fiscal stimulus packages almost every year in the 1990s. However, many empirical studies, such as Ihori *et al* (2003), Nakazato and Konishi (2004), Fujii (2008), Eguchi and Hiraga (2009) and Miyazaki (2010), show that the fiscal policies of the 1990s were not effective. Some studies find that fiscal expansion reduced private demand, especially corporate sector investment. However, the fiscal policy response in the post-bubble period was a partial cause of the ensuing public financial deterioration.

In this chapter, we summarise the movement of the Japanese economy from the mid-1980s to the early 1990s and the fiscal policy response after the bubble periods. First, we depict the emergence and subsequent bursting of the land-price bubble in the late 1980s by analysing the economic policy during this period. We also describe what happened to corporate investment after the collapse of bubble[20]. Second, we analyse the fiscal policy and corporate response in the post-bubble period by presenting earlier works on effectiveness of fiscal policy in Japan. Here we focus on the studies that examined the effects on corporate investment.

In section 2, we summarise the movement of the 'bubble' in the mid-1980s to the early 1990s in Japan. Section 3 presents the fiscal policy response after the bubble period and some earlier works on fiscal policy effectiveness in these periods. Section 4 concludes.

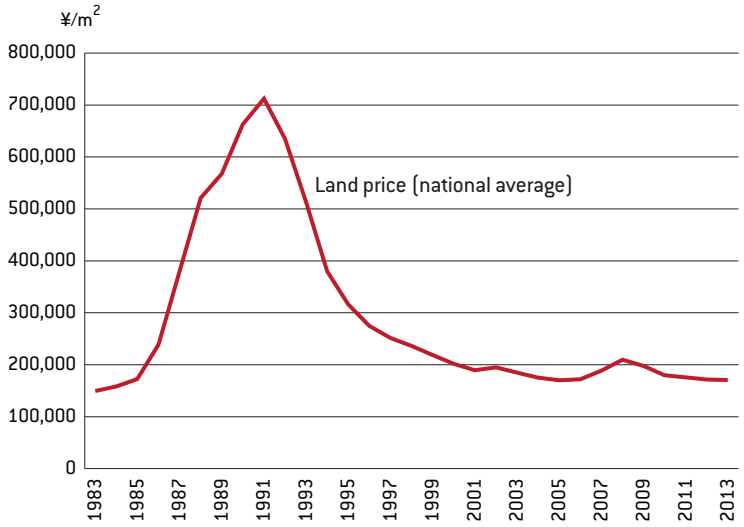
2. The creation and bursting of the bubble in the late 1980s in Japan[21]

2.1. The creation of the bubble in the latter half of the 1980s

The late 1980s to the early 1990s are called a bubble period, and correctly so in terms of land prices. As Figure 1 shows, land prices in this period were the highest in two decades, hitting a ceiling in 1991[22]. According to the Economic Survey of Japan, conducted in 1988 and 1989, the gap between actual and theoretical land prices was particularly large in the years 1986-89. This means that land prices in this period were too high relative to the level implied by market fundamentals, and this suggests that the high price of land was the result of a bubble[23]. As shown in Ishi (2008), commercial land prices in Tokyo soared and this spread to the residential price in Tokyo. After that, land prices in both Osaka and Nagoya began to rise, and rising prices propagated nationwide.

20. The asset price bubble around the late 1980s also had an aspect as a stock price bubble. However, to be consistent with the theme of this volume, our arguments focus on housing and land prices. Moreover, we only depict the movement of land prices in this chapter because the bubble economy around the late 1980s was caused by the land prices rather than housing prices.
21. Most of the arguments in this section are indebted to Asako (2000) and Asako (2012).
22. The data of land price in Figure 1 is official land price data provided by Ministry of Land, Infrastructure, Transport and Tourism. Although this data does not necessarily reflect actual market prices traded in the market, we have nothing but to use this data. This is why there seems to be no other good indicator of the land price that reflects the actual market price properly. Pay attention to this point.
23. For more details, please see Asako (2012).

Figure 1: Land price movement in Japan (national average)



Source: http://www.chika-data.com/.

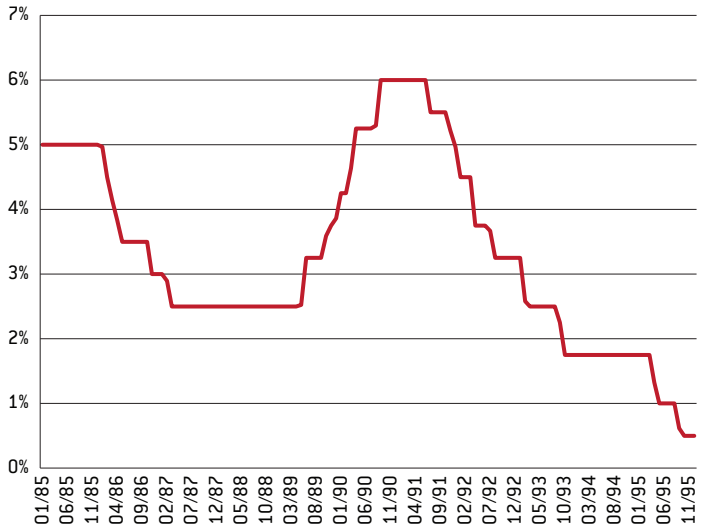
One possible cause of the land price bubble was the Bank of Japan's expansionary monetary policy. The official discount rate, which the Bank of Japan used as a policy interest rate until 1993, was cut five times beginning in January 1986[24]. The Bank of Japan cut the official discount rate in order to deal with an economic slump. The Plaza Accord and the resulting appreciation of the yen hurt Japanese exports, causing the slump. From February 1987 to May 1989, the official discount rate remained at 2.5 percent, the then-lowest rate since the founding of the Bank of Japan (Figure 2).

While the monetary loosening policy was intended to devalue the yen, it caused excess liquidity – in other words, an unusual supply of liquidity to the market. Moreover, the accumulation of the net foreign wealth thanks to the current account surplus in these periods also accelerated the supply of liquidity. The excess liquidity caused a rise in asset prices and as a result land prices increased (Figure 1)[25].

The monetary loosening policy and the increase in land prices contributed to the credit

24. The official discount rate is the interest rate used when the central bank lends money to the commercial bank.
25. There are some channels via which the excess liquidity influences the asset prices. For this point, see Adalid and Detken (2007).

Figure 2: Official discount rate (January 1985-December 1995)



Source: Nikkei NEEDS Database.

expansion[26]. Incidentally, when investors or companies borrowed money, land and other real estate was often used as collateral in Japan. This reflects the 'land myth' that land prices would continue to rise. There is no doubt that the higher the price of land, the more attractive land became as collateral. As a result, financial institutions held large volumes of loans secured with land.

2.2. The bursting of the bubble and the corporate response

The increase in asset prices spread to the real economy, and the Japanese economy enjoyed prosperity. However, both the Japanese government and the Bank of Japan were concerned about the asset price bubbles. Thus, they adopted some austerity measures.

First, the Bank of Japan raised the official discount rate starting in May 1989. The official discount rate reached 6.0 percent in September 1990. However, the increase in land prices did not stop at that point: even if the policy interest rate was raised, there may have been a time lag before its effects spread.

26. Moreover, Hattori *et al* (2009) point out that another cause of the credit expansion was the deregulation in the capital markets that relaxed existing restrictions on bond issues and by the introduction of time deposits with liberalised interest rates.

Second, the government introduced quantitative restrictions on real estate lending in March 1990. Although this policy was done to suppress the increase in land prices, it was so radical that the Japanese economy worsened. Asako (2012) points out that this policy was a turning point towards a drop in land prices.

Third, the government announced a series of reforms to the land-tax system, such as the introduction of a land-value tax[27].

Finally, the government expanded the designation of districts subject to land-price monitoring. As a consequence of these tightening policies, the bubble burst, and land prices fell drastically in 1992 (Figure 1).

The drop in land prices led to concerns about credit at financial institutions, which held large volumes of loans secured against land. The drop in land prices caused a problem of bad or non-performing loans. Moreover, the negative wealth effect caused by the sharp fall in land prices reduced private demand.

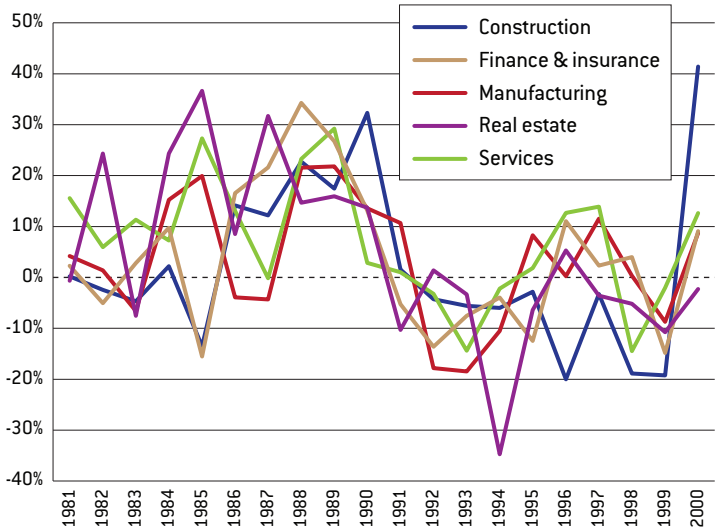
Figure 3 shows the trend in corporate investment (including construction in progress) from 1980 to 2000. This figure tells us that the drop in corporate investment after the bursting of the bubble coincided with the drop in land prices. Moreover, the drop is prominent in the construction and real estate industries, for which land plays an important role. There are three reasons for the drop-off in corporate investment. First, it was a reaction to the over-investment during the bubble period. Second, financial institutions were reluctant to lend money to companies for various reasons. Third, the companies themselves had to cut their investments because of the negative wealth effect mentioned above.

3. The fiscal policy response

In the post-bubble period, both the Bank of Japan and the government conducted an expansionary monetary and fiscal policy in order to support the economy. In this section, we first summarise the expansionary fiscal policy of the 1990s. Second, we discuss some earlier studies on fiscal policy effectiveness in these periods in Japan. We especially discuss the effects of public investment on corporate investment (private investment).

27. Incidentally, Ishi (2008) points out that political posturing prevented the land-value tax from being effective to suppress land prices.

Figure 3: Corporate investment (% change from previous year)



Source: Cabinet Office of Japan.

The Japanese government implemented many stimulus packages as supplemental budgets throughout the 1990s, as shown in Table 1. Although income and corporate tax reductions and financial assistance to small and medium enterprises (SMEs) were included, stimulus packages mainly involved public investment, particularly in infrastructure. This made up most of the supplemental budget planned as a stimulus package in August 1992, April 1993, September 1993 and September 1995.

One reason for this is that whereas the Public Finance Act prohibits the issue of deficit bonds in principle, the Act allows limited bond issuance in the General Account (the Japanese central government's budget) to raise funds to finance public investment, equity investment and loans to public corporations[28]. Reflecting this, construction bonds formed most of the Japanese central government's bond issuance in the 1990s, as shown by Figure 4[29].

28. The Japanese government issues special deficit-financing bonds to finance a deficit for non-investment purposes by enacting a law effective for only one year (see Doi and Ihori, 2009).
29. Moreover, the local governments were also involved in the in stabilisation efforts initiated by the central government through their investments, as shown in Hanai *et al* (2000), Pascha and Robaschik (2001), Doi and Ihori (2009) and Miyazaki (2009). Since local governments also increased their investment by issuing the construction bonds of prefectures or municipalities, the local government debt outstanding had rapidly increased shortly after the collapse of the bubble.

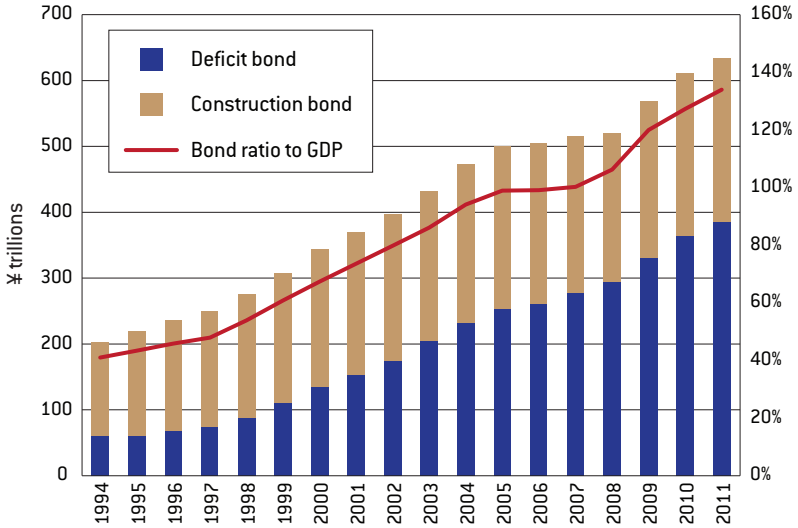
The other reason is that public investment in Japan has an aspect of pork-barrel spending, as shown by Kondoh (2008) and Doi and Ihori (2009). That is, since public investment in Japan can be used to support local regions, political pressure from local interest groups might increase the size of public investment and the rural areas might share most of it. In fact, while the size of public investment increased in the 1990s, there was relatively more public investment in rural areas than in urban areas such as Kanto, Tokai and Kansai, in the 1990s (Figure 5). This suggests that although numerous public investment programmes were implemented as fiscal stimulus packages, most of them were allocated to rural areas.

Table 1: Chronology of economic stimulus packages and tax cuts in the 1990s

Stimulus packages	Tax cuts	
Date of announcement	Date of announcement	Date of implementation
August 1992		
April 1993 September 1993	April 1993	December 1993 & June 1994
February 1994	February 1994 September 1994	July 1994 & December 1994 January 1995, June1995, & December 1995
April 1995 September 1995	December 1995	June 1996 & December 1996
	December 1997	February 1998, June 1998, December 1998, and June 1999
April 1998 November 1998	April 1998	August 1998
November 1999		

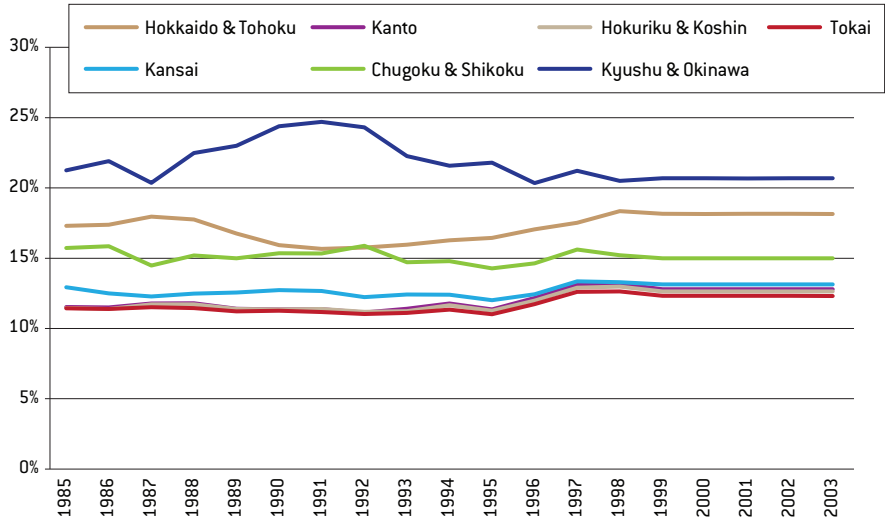
Source: Miyazaki (2010).

Figure 4: The size of outstanding Japanese central government bonds (left scale), and ratio to GDP (%, right scale)



Source: Ministry of Finance.

Figure 5: Regional share of public investment in Japan



Source: Cabinet Office of Japan.

However, public investment has two asymmetric effects on corporate investment. One effect is crowding-in, that is, the increase in public investment stimulates corporate investment. The other effect is crowding-out. If this is the case, public investment reduces corporate investment. According to Kozuka *et al* (2012), the crowding-out effect was observed by most previous Japanese empirical studies such as Ihori *et al* (2003), Nakazato and Konishi (2004), Fujii (2008) and Eguchi and Hiraga (2009)[30]. In particular, this is prominent in the studies that add the 1990s to the sample periods.

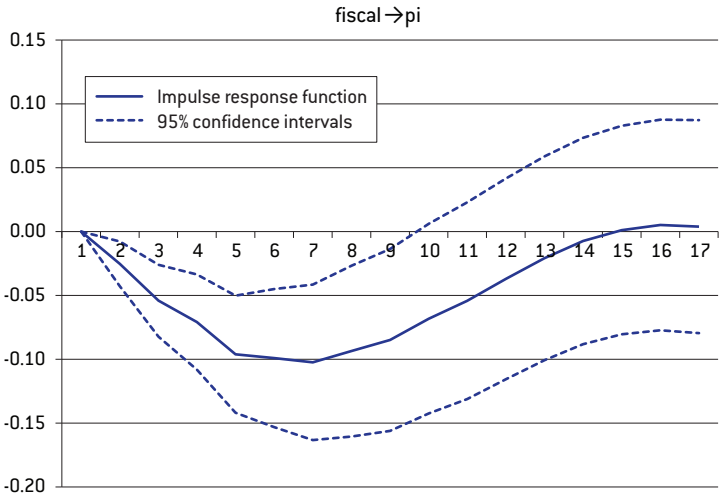
Moreover, Miyazaki (2010) examined the effects of fiscal policy in the 1990s in Japan by using a 'narrative approach'. This enables us to examine policy effects using a time-series method in conjunction with an event study. Using this approach, we consider not only the size and persistence of each policy change, but also the effects of different fiscal policies in different periods.

To identify policy effects, Miyazaki (2010) used dummy variables to capture policy changes, following the chronology shown in Table 1. Figures 6a to 6c show the impulse response functions of the shocks of economic stimulus packages with respect to the variables related to corporate investment per potential GDP (PGDP) by using the results of Miyazaki (2010)[31]. Figure 6a shows the results of the 1990s stimulus packages ('fiscal') with respect to corporate investment per PGDP ('pi'). This figure tells us that there was a negative response in terms of corporate investment to the fiscal expansion throughout the 1990s. Figure 6b shows the results by dividing the investment into non-residential investment per PGDP (non-r.inv) and residential investment per PGDP (r.inv). Although crowding-out is observed in both cases, the negative response in terms of non-residential investment was substantial. Figure 6c shows the results when we divide the periods of the announcement and implementation of the economic stimulus packages into the former half (fiscal 1) and latter half of the 1990s (fiscal 2). Although a negative response was observed in all cases, only the response to the packages in the latter half of the 1990s with respect to non-residential investment was statistically significant. The results of Miyazaki (2010) imply that the crowding-out effect occurred in the 1990s especially for non-residential investment, and fiscal expansion in these periods was not effective in terms of stimulating the corporate to invest.

30. A recent paper by Fujii *et al* (2013) examined the crowding in/out effects of public investment by using sectoral private investment data and shows the results that the effects are different depending on the characteristics of industries.
31. Miyazaki (2010) shows the results of impulse response functions by using tables instead of figures for the sake of brevity. Detailed results are shown in Miyazaki (2010) and other figures can be obtained from the author on request.

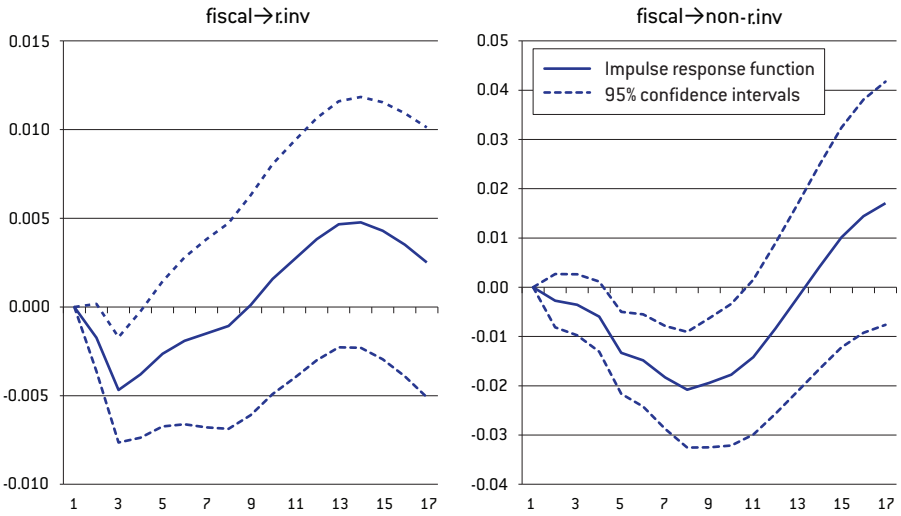
The crowding-out effect observed in Japan might partly be attributed to the allocation of public investment. As Figure 5 shows, most public investment implemented as stimulus packages in the 1990s in Japan was likely to have been allocated to rural areas. In general, the productivity of rural areas is low. In line with this, the crowding-out effect might also be relevant as an indication of the inefficiency of interregional allocation, because public investment allocated predominantly to rural areas instead of urban areas does not contribute to the promotion of an increase in corporate investment but rather inhibits it.

Figure 6a: Impulse response function of Miyazaki (2010) ('Case 1' in Miyazaki, 2010)



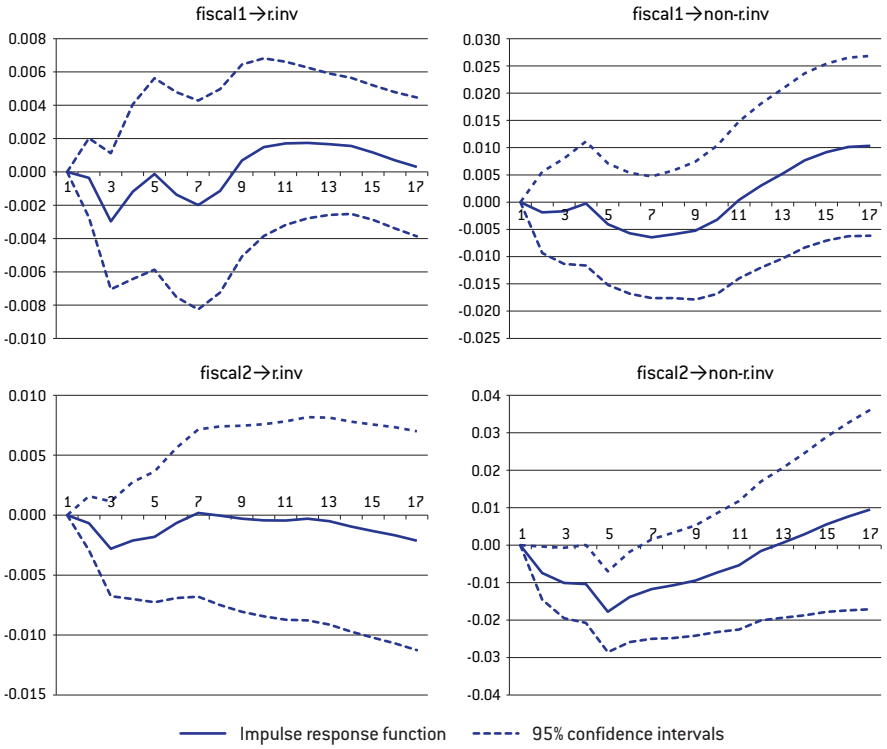
Note: The figure displays the results on policy shock 'fiscal', which indicates the periods of the announcement and implementation of economic stimulus packages throughout the 1990s, with respect to corporate sector's investment per potential GDP ('pi'). The upper limit of each impulse response function is sixteenth quarters. The solid lines represent the impulse response functions for a dummy variable for fiscal policy. The dashed lines represent the 95 percent confidence intervals.

Figure 6b: Impulse response function of Miyazaki (2010) ('Case 2' in Miyazaki, 2010)



Note: The figure displays the results on policy shock 'fiscal', which indicates the periods of the announcement and implementation of economic stimulus packages throughout the 1990s, with respect to non-residential investment per potential GDP ('non-r.inv') and residential investment per potential GDP ('r.inv'). The upper limit of each impulse response function is sixteenth quarters. The solid lines represent the impulse response functions for a dummy variable for fiscal policy. The dashed lines represent the 95 percent confidence intervals.

Figure 6c: Impulse response function of Miyazaki (2010) ('Case 4' in Miyazaki, 2010)



Note: The figure displays the results on policy shocks with respect to non-residential investment per potential GDP ('non-r.inv') and residential investment per potential GDP ('r.inv'). 'Fiscal 1' indicates the periods of the announcement and implementation of economic stimulus packages in the former half of the 1990s, and 'fiscal 2' identifies the periods of the announcement and implementation of economic stimulus packages in the latter half of the 1990s. The upper limit of each impulse response function is sixteenth quarters. The solid lines represent the impulse response functions for a dummy variable for fiscal policy. The dashed lines represent the 95 percent confidence intervals.

4. Conclusion and main messages

In this chapter, we first discussed the development and bursting of land-price bubbles in the late 1980s in Japan. Second, we presented the results of past research on Japanese fiscal policy during the post-bubble periods. Previous research showed that the impact of public investment was not positive for corporate investment. Thus, fiscal policy in the 1990s was not necessarily adequate in terms of stimulating the corporate

sector's incentive to invest. Moreover, because of the large stimulus packages implemented almost every year in the 1990s, the government's financial condition worsened. Whereas the debt-to-GDP ratio reached almost 140 percent (Figure 4), which is the highest among developed countries, there is no doubt that one reason for this was the policy response in the 1990s.

For policymakers, there are two lessons from this.

First, monetary loosening policies can sometimes cause asset price bubbles as affirmed by the experience of the late 1980s in Japan. In principle, policymakers should not create bubbles, though bubbles sometimes emerge. Further, as Alan Greenspan, former chairman of the Federal Reserve Board, has said, *"we recognised that, despite our suspicions, it was very difficult to definitively identify a bubble until after the fact – that is, when its bursting confirmed its existence"*[32]. However, policymakers might be required to deal with the bubble boom 'gradually' if they see evidence of a bubble developing. The austerity measures deployed in rapid sequence in the early 1990s in Japan contributed to the bursting of the bubble. Policymakers should be careful not to make the same mistake that the Japanese government made. Second, public investment was frequently used as part of the stimulus packages implemented in many developed countries after the 2008 global financial crisis. However, it has asymmetric effects on corporate investment. The Japanese case tells us that the crowding-out effect is strong. Governments should carefully plan policy based on the movement of public and private investment in discussing the contents of stimulus packages. One suggestion is that the government should invest heavily in urban areas or industries with high future growth potential, unlike the Japanese case, as discussed in section 3. In terms of both achieving economic growth and stabilising the macroeconomy, the government should use its budget for urban area or for sectors that are expected to grow, even when public investment is planned as a part of economic stimulus packages.

This chapter is based on my presentation at the congress 'Japan and the EU in the global economy: challenges and opportunities', held on 7 October 2013. I would particularly like to thank Guntram Wolff for valuable comments and suggestions. The comments from Joachim Fels, Shigeto Kitano, Masafumi Kozuka, Kiyohiko G. Nishimura and Michael G. Plummer were also very useful to polish the paper. This work was financially supported by a Grant-in-Aid for Scientific Research (Young Scientist) and financial aid from the Zengin Foundation. The usual disclaimer applies.

32. See the webpage http://www.federalreserve.gov/boarddocs/speeches/2002/20020830/.

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Part 3:

Monetary, fiscal policy and the financial system in Japan and Europe: a comparative perspective

When central bank independence is challenged by unconventional monetary policies

WATARU TAKAHASHI

Summary[33, 34]

In the aftermath of the global financial crisis, a number of major central banks have implemented unconventional monetary policies (UMPs). This paper discusses problems related to UMPs from the perspective of central bank independence, which is being challenged in both practice and theory. As many central banks are now required to pursue three types of stability – price, financial and fiscal – there are areas of potential conflict with governments. In addition, the lack of a policy rule for UMPs erodes accountability. The theory of central bank independence, which was designed to control inflation, should therefore be reviewed. I propose a new approach to central bank independence from the viewpoint of political economy.

33. This chapter is based on my presentation titled 'Common Issues Central Banks Face on Unconventional Monetary Policies' at the symposium on *Japan and the EU in the global economy: challenges and opportunities*, held by Bruegel, Kobe University and Foundation France-Japon de l'EHESS on 7 October 2013 in Brussels. I would like to thank my paper's discussant, Zsolt Darvas, for his thoughtful and useful comments, and am grateful to the other conference participants.
34. This work was supported by JSPS KAKENHI Grant Nos. 24243024 and 25285100.

1. Introduction

This chapter discusses problems posed by unconventional monetary policies (UMPs) from the viewpoint of the institutional framework of central bank independence. After the Great Moderation that began in the mid-1980s, the importance of price stability for sustainable economic growth became widely recognised. Price stability became the sole objective of monetary policy, and a number of central banks obtained independence from governments. At the same time, given the role that they play in a democratic society, central banks were required to act with transparency and accountability in return for independence.

In addition to disclosure of decision making by publishing the minutes of policy meetings, holding frequent press conferences and speeches and using other platforms, the setting of policy rules has been regarded as important to enhance accountability and transparency. Many central banks have adopted inflation targeting; the presentation of numerical targets clarifies the policy objective. Furthermore, because rule-setting is important for the control of policy variables such as money market rates, many central banks have adopted the Taylor Rule for the adjustment of policy variables, or at a minimum they refer to this rule. It is thought to minimise the room for discretion and is regarded as a device for maintaining self-discipline in terms of accountability.

The situation has changed utterly, however, since central banks began adopting UMPs following the recent global financial crisis. Many scholars have argued that since UMPs contain quasi-fiscal policies, they should be implemented with government oversight. And it has also been claimed that because central banks are expanding their territories as they carry out bank supervision in the name of macro-prudence, such activities should also be coordinated with the government.

This chapter discusses another aspect of central bank independence in the current situation, that is, the lack of policy rules. As quantitative easing (QE) is widespread, UMPs have not established a clear rule for the control of policy variables such as the outstanding balance of the current account at the central bank. Since UMPs have become discretionary, they are criticised as not sufficiently accountable, even though central banks have strengthened their communication to the markets. In addition, it generates a fallacy in economics. Economic theory supplies a foundation for central bank independence with a view to controlling inflation. But the theoretical foundation for central bank independence may be eroded in an era of deflation. In the light of the recent situation of deflation, therefore, this theoretical foundation should be reviewed.

I briefly discuss UMPs in section 2 and discuss policy effectiveness in section 3. Since the Bank of Japan was the first modern central bank to establish a UMP, its experience is reviewed in section 4. After discussing problems related to UMPs in section 5, I present a different approach to central bank independence in section 6. Concluding remarks appear in section 7.

2. Taxonomy of UMPs

When the Bank of Japan began its zero interest rate policy in 1999, it was thought to be exceptional and considered to be temporary. The Bank of Japan continued extraordinary policies such as QE in 2001-06, comprehensive monetary easing (CME) in 2010-13, and quantitative and qualitative easing (QQE) from 2013. Following in the footsteps of the Bank of Japan, central banks in many other major industrial economies adopted similar policies following the global financial crisis.

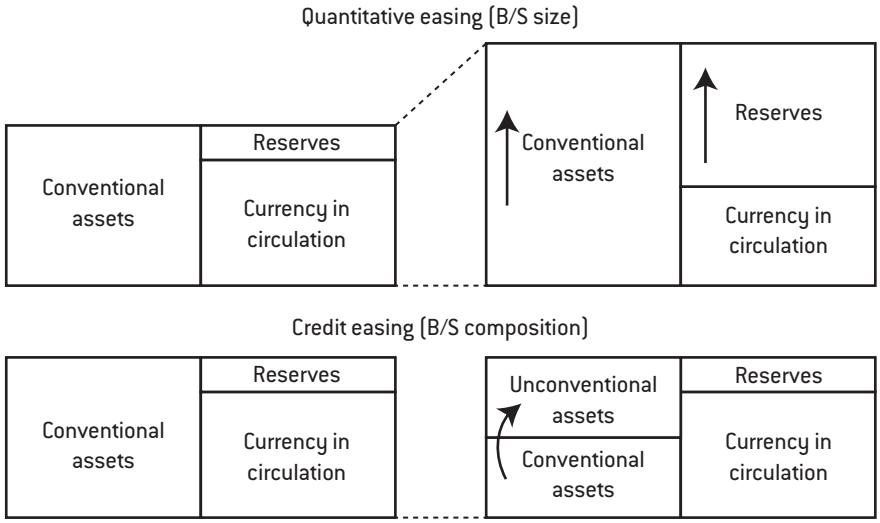
Broadly speaking, UMPs can be categorised into three types: (1) QE, (2) credit easing (CE), and (3) forward guidance (FG).

The first and second types, QE and CE, are essentially tools for liquidity control of the financial market and financial sector. By means of QE, a central bank expands its balance sheet by injecting liquidity into its current account balance. With CE, a central bank changes the composition of its assets by purchasing risky assets for which the market has usually been destabilised by a financial crisis (Bernanke, 2009).

Even though QE might be said to affect the liability side and CE the asset side, both policies are categorised as 'balance-sheet policy' because their effects are seen initially on the balance sheet rather than through interest rates or other economic variables. By means of balance-sheet policy, many central banks also increase the number of financial products for purchase through monetary operations, and they reduce the credit standards of products and collateral. These measures are similar to QE and CE policies, but such actions had been already taken during previous crisis periods. In more recent episodes, however, when QE and CE were deployed, central banks tended to serve as the lender of last resort, not to an individual bank, as in previous periods, but to the entire system or market.

By committing to continue a particular policy until a fixed date or when certain economic conditions are met, central banks control long-term interest rates by influencing market expectations. This third type of UMP, FG, is not uniquely a UMPs. In the United States, increases in interest rates at a 'measured pace' were implemented

Figure 1: Balance sheet policies



Source: Shiratsuka (2010).

by the Federal Reserve from 2004 to 2006. Japan also made a commitment to boost domestic demand until its external imbalance was adjusted, which created a 'bubble' by continuing a low interest rate policy in the late 1980s.

3. Evaluation of UMPs

In principle, monetary policies succeed by working on interest rates and asset values together. As the interest rate reaches zero and remains there, the wealth effect becomes the only remaining channel for monetary policy. It is not surprising, therefore, that a one-handed policy is less effective than a conventional two-handed policy.

Although FG is found to be somewhat effective in reducing long-term yields, it is another matter for it to boost investment and consumption.

While some economists have cited the effectiveness of UMPs, many think that UMPs are effective for restoring financial stability but less so for boosting economic activity (Woodford, 2012).

From the viewpoint of financial stability, the effects of UMPs are significant. By means of (1) QE, the provision of ample credit by central banks eases the liquidity shortage of banks. And (2) CE is a more direct measure to resolve the malfunctioning of a particular market. For example, a large-scale purchase of mortgage-backed securities (MBSs) by the Federal Reserve managed to restore the mortgage market that had been heavily damaged by the US sub-prime crisis. In Europe, the announcement of the start of large-scale unlimited purchases of peripheral debt by the European Central Bank stabilised the government bond markets.

At first, UMPs were adopted as emergency measures for financial stability. But gradually it began to be expected that they would boost economic activity in place of conventional monetary policies.

Of the three types of UMPs, FG – although regarded previously as supplementary to QE and CE – has become a major policy tool for economic recovery. Following the zero interest rate policy of the Bank of Japan, which committed in 2000 to continuing the policy until deflation concerns dissipated, the Federal Reserve followed with QE1 and the initially reluctant Bank of England finally adopted FG in 2013. Both announced the continuation of UMPs until unemployment rates dropped to a certain level.

While many empirical studies of QE and CE have been carried out, the results have been mixed. It is also difficult to distinguish the effects of QE and CE from those of FG, so the exclusive effects of QE and CE have not been established. In Japan, the results are also mixed for QE (Ugai, 2007). Some studies found no positive results, while others found the contrary (Honda, Kuroki, and Tachibana, 2007). Recent work by the Bank of Japan (Kimura and Nakajima, 2013) reveals that UMPs show a positive coefficient with economic activity but are empirically ineffective. This appears to be the most convincing result for policymakers in Japan thus far[35].

UMPs also pose problems in terms of reducing the size of the balance sheet (QE) and discarding risky assets (CE). Some argue that this 'exit' problem could be resolved by moving slowly. However, if an economic recovery materialises, it is expected that bond prices would fall. Some argue that since central banks hold long-maturity assets because of QE and CE, they would suffer a huge loss from the rising long-term yield, which – ironically – would result from an economic recovery. Some have argued that

35. While some argue that unconventional policies had some positive effects on economic recovery in Japan, it is fair to say that recovery was mainly supported by other factors such as the resolution of the non-performing loan problem in the Japanese banking sector and an increase in external demand resulting from growing global trade after China joined the World Trade Organisation in 2001. The effect of monetary policy alone is not so clear.

the loss should be compensated for by the government, raising the issue of central bank independence.

FG also entails a problem. Since it generates an expectation that low-interest rates will continue for a long time, it encourages speculation by increasing leverage, which could heighten the volatility of interest rates.

FG entails a commitment that resembles a policy rule. But as many have already pointed out, it is essentially a discretionary policy for the control of policy variables. Inflation targeting has the same nature; it can become a rule-type policy equipped with the Taylor Rule. Furthermore, the recent targeting of unemployment by FG poses a problem, even though monetary policy cannot control real variables. Unemployment can only be considered by monetary policy in the context of its influence on inflation. So even if we admit that FG is a rule-type policy, the wrong targets are assigned as its objective.

Finally, FG would be also difficult to terminate[36], because it can create expectations that are difficult to change without confusion. In seeking to avoid confusion, central banks are liable to be timid, as shown by the recent experience of 'tapering' QE3 in the United States[37].

4. Experience of the Bank of Japan

Takahashi (2013) reviewed more than 10 years of the history of UMPs conducted by the Bank of Japan after it became independent in 1998. While the Bank of Japan does not officially discuss 'mistakes' in policy operations, in retrospect some aspects of the operations might have been accomplished with more success.

A. Exit from the zero interest rate policy in 2000 and the QE in 2006

In the cases of the exit from the zero interest rate policy in 2000 and from QE in 2006, the Bank of Japan was criticised for acting prematurely. In the case of the exit from QE

36. Rajan (2013) discussed the difficulty of 'exit' from Unconventional policies by focusing on the 'credibility' of central bank policies.
37. When the Federal Reserve Board (Fed) announced the termination of QE in May 2013, there was a huge drop in stock prices. But when a similar announcement was made in December 2013, the stock prices rose. This contrast could be a result the Fed's suggestion to extend the zero interest rate in December. Although the termination was focused on unconventional policies, this episode proves the first increase in the interest rate after the exit from unconventional policy is more important for markets. The Bank of Japan experienced a similar reaction when it stopped QE in 2006.

in March 2006, the Bank of Japan announced the condition that it would continue QE until the consumer price index inflation rate was stably above zero percent. However, the target of zero inflation was too low as a condition for the exit.

A more serious episode was the first increase in interest rates in October 2006. The Bank of Japan explained that as inflation rose, the real term interest rate that was calculated by deducting the inflation rate from the nominal interest rate, would fall and that a small increase in the policy rate would not have a negative effect. It was thought that the time had come to take precautionary action.

Central banks have judged that precautionary policies are desirable to conduct forward-looking monetary policy. This lesson was learned during the era of inflation in the 1970s and 1980s. The situation of the zero lower bound interest rate produced another monetary policy lesson, which states that backward-looking policy action is desirable in the context of a zero interest rate, labelled as the theory of 'historical dependence'[38]. Since this theory became formalised after the Lehman crisis, the Bank of Japan did not fully take on this lesson when it terminated QE in 2006.

B. Poor reaction to exchange rate changes during the CME period

The Bank of Japan launched comprehensive monetary easing (CME) in October 2010. Although the Japanese financial sector was relatively less affected by the Lehman crisis, the manufacturing and other non-financial sectors were heavily impacted. The most damaging factor was a rise in exchange rates, which ironically reflected the comparative financial soundness of the Japanese financial sector compared to those of the United States and Europe.

Even though the responsibility for exchange-rate policy in Japan belongs to the Ministry of Finance and not to the central bank, the Bank of Japan showed great concern about exchange rates, given their great influence on the economy.

By means of CME, the Bank of Japan set up a separate fund to expand its balance sheet by purchasing Japanese government bonds and began to purchase real estate investment trusts and exchange-traded funds. This combined QE and CE. In terms of FG, the Bank of Japan announced the continuation of policy by setting the timing of termination.

38. For the theory of 'Historical Dependence', see Woodford (1999) and Eggertsson and Woodford (2003).

This degree of monetary easing was bold at the time. The outstanding current account balance, which is considered a measure of monetary easing, exceeded the highest peaks during the QE period. But the Bank of Japan's policies continued to be criticised as too little, too late.

In fact, the policy measures were sometimes reactive. Decisions were often made after an appreciation in exchange rates, and it was claimed that quicker action could have prevented such an appreciation. Policy actions also seemed *ad hoc* and discretionary. Even though the Bank of Japan published the schedule of increases in funds, it did not reflect economic conditions.

In autumn 2012, the soon-to-be prime minister, Shinzo Abe, began to heavily criticise the Bank of Japan for its 'reluctance' in monetary easing. This was perhaps the strongest attack on the independence of the Bank of Japan in more than a decade. The Bank of Japan had not succeeded in establishing its policy rule, a weakness that invited criticism from the political sphere.

This situation might be taken to show that even after a central bank obtains legal independence, to maintain autonomy it is not sufficient for it to conduct policy independently. Following the establishment of its independence, the Bank of Japan sought to avoid political conflict, by accepting the minimum requirement in response to the government. But this strategy appears to have failed. From this experience, a lesson might be drawn that a central bank should take a more proactive stance in reacting to government policy.

5. Problems of central bank independence under UMPs

The notion of independence is designed for a central bank that pursues only price stability in its monetary policy during an era of inflation, and that engages solely in the conduct of monetary policy. In line with this thinking, as typified by the Bank of England, the function of bank supervision is separated from the central bank and the central bank concentrates on controlling inflation.

The global financial crisis, however, reminds us of the importance of the central bank's lender-of-last-resort function. The crisis also suggests that since central banks know the market well, it is appropriate for them to supervise the banking sector. Thus, central banks have taken on the responsibility for bank supervision in the name of macro-prudence and expanded their regulatory territory. For example, the Federal Reserve has expanded its responsibility within the banking sector, and financial intermediaries

such as life insurance companies have come under the supervision of central banks in some countries.

In addition, since public debt has increased dramatically in many countries, the control of public debt has become a great concern for central banks. As suggested by the fiscal theory of the price level, central banks could lose control of inflation if the sustainability of public debt is given priority over price stability.

In place of the former arrangement in which a central bank pursued only price stability, today's central banks are considering three types of stability: price stability, financial stability and fiscal stability. Needless to say, the second and third types are judged to be the business of government. Thus, central bank independence has become an issue.

The theory of central bank independence has also been challenged. Essentially, it is designed for control of inflation. As explained by Rogoff (1985), since the government and politicians are inflation biased, the control of inflation should be assigned to a conservative central bank that has a reputation as an inflation fighter.

Following the conservative central bank model, in an era of deflation, it could be claimed that central bank independence should be relinquished to overcome deflation. Such a fallacy must be reviewed.

6. A new foundation for central bank independence[39]

When central bank independence loses the foundation according to which central banks pursue only price stability under the condition that the government and politics are inflation biased, another foundation for independence becomes necessary.

I would argue that this reflects the fundamental and deep problem of the relationship between politics and the economy. Although many economies required a great deal of support from governments following the financial crisis, the ideal is that economies should be self-governed with minimum government intervention. Historically, capitalist economies have a tradition of self-governance. For example, the City of London has sought to keep its distance from the Westminster, the seat of government, for centuries. In Japan, even during the centralised rule of the Tokugawa Shogunate during the Edo

39. Part of this section was inspired by a discussion at a conference held by Cornell Law School in New York, February 2013. I would like to thank Professor Annelise Riles of Cornell for her kind invitation and suggestions.

Period (1603–1867), the Dojima market for rice futures in Osaka was managed by a self-governing merchant's guild.

Even though central banks have been established by their respective states, central banks are positioned at the centre of the economy. As the economy should operate on a self-governing basis, a central bank should be independent from the government and politics.

The degree and nature of independence depends on the distance between politics and the economy in each nation. When an economy is still underdeveloped, the government plays a major role and central bank independence might be weak. As the economy develops, however, regulations are modified and privatisation proceeds. In this sense, central bank independence is similar to privatisation, in which the economy should operate based on the market mechanism.

As a pillar of the market, the central bank's philosophy is that its intervention in the market should be minimised. According to this principle, the central bank should control the short-term spectrum of interest rates and it is desirable to maintain a small balance sheet. Needless to say, as government intervention in the economy has proceeded, since the crisis central banks have moved in the opposite direction.

If a central bank begins to consider financial stability and fiscal stability in addition to price stability, it increasingly comes to resemble a political entity. Even if we admit that a central bank plays a role similar to that of the government, its independence should be maintained in a constitutional framework so long as the idea of self-governance of the economy is shared by society. A constitutional framework mandates the independence of a public entity to achieve a separation of powers. This factor should be considered in support of the argument for central bank independence.

7. Concluding remarks

Although central banks have become politicised in the current circumstances, central bank independence should be maintained as a pillar of self-governance in the economy. Economics tends to avoid analysing the political dimension of economic policy. But it has become increasingly necessary in the current environment to consider this political dimension in relation to central banks. A constitutional framework, which stipulates the independence of a public entity by separation of powers, offers promise for potential consideration.

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Monetary, fiscal and financial policies in Europe and Japan: comments on 'When central bank independence is challenged by unconventional monetary policies' by Wataru Takahashi

ZSOLT DARVAS

Fiscal dominance and monetary policy

The issue of fiscal dominance was a central theme in 'When central bank independence is challenged by unconventional monetary policies' by Wataru Takahashi. Fiscal dominance describes a situation in which there is a threat to fiscal sustainability because of large public debt and budget deficits, potentially endangering financial and macroeconomic stability. Such a situation limits the freedom of the central bank (either indirectly by internalising the threat from fiscal unsustainability, or directly by pressure from the government) in pursuing the price-stability goal.

Mr Takahashi carefully underscored the risks to central bank independence in Japan resulting from the high public debt (which forces the Bank of Japan to consider fiscal sustainability too when making monetary policy decisions), the possible political

interference in the Bank of Japan by the government, and the large and increasing holdings of government securities by the Bank of Japan (which exposes the Bank of Japan to losses if interest rates were to rise).

Separately, it has been highlighted, with a focus on the role of the European Central Bank (ECB), that the most important challenge is to avoid fiscal dominance in order to preserve credibility and independence. It has been emphasised that beyond helping to mitigate the escalation of the crisis, the ECB has entered the border area of fiscal policy and has also gained weight in other important policy fields, such as banking supervision (as the ECB will be the single supervisor of major euro-area banks from late 2014) and in the design, approval and monitoring of financial assistance programmes for euro-area countries.

While sharing most of these conclusions, I would like to offer three main and interrelated comments:

(1) The need for and the effectiveness of unconventional monetary policies,

(2) The appropriateness of fiscal adjustment strategies during the current crisis, and

(3) The problems with low inflation.

Comment 1: Unconventional monetary policies

First, the limits of unconventional monetary policies, like quantitative easing of the Federal Reserve, Bank of Japan and Bank of England and the unlimited liquidity provision of the European Central Bank (ECB) have been highlighted. Mr Takahashi also argued that while unconventional monetary policies were effective in restoring financial stability, they were comparatively less effective in boosting economic activity, such as investment and consumption. He also criticised the less-accountable nature of unconventional monetary policies, since clear policy rules, such as a Taylor-rule (which is a simple equation prescribing the central bank interest rate as a function of inflation and a measure of economic activity), cannot be set.

I agree that unconventional monetary instruments have major limitations, but the main question is what alternative was there? When the central bank interest rate reaches the zero lower bound, traditional central bank instruments became powerless. A central bank then can either just sit there doing nothing and hope that other policy areas, such as structural reforms and fiscal policy, will solve all problems, or it can experiment with

new and unconventional instruments. Since high inflation was not a threat (instead, the risk of deflation increased in advanced countries), the economies were well below potential, a prolonged process of private sector deleveraging was seen coming and there was a major shortage in demand, it was the right choice to opt for unconventional monetary policies at the height of the global financial and economic crisis. Furthermore, in most advanced countries, including the United States, fiscal authorities started consolidation strategies after 2009, implying that even the initial 2008-09 fiscal boost to the economy has reversed. Without unconventional monetary policies, economic outcomes would have been much worse and therefore it is difficult to argue that such policies did not contribute well to investment and consumption. Until inflation and inflationary expectations are below target and financial stability is ensured and is expected to prevail, there is a rationale for unconventional monetary policies when economic conditions are adverse.

In the specific case of Japan, the exchange rate of the yen appreciated remarkably after the collapse of Lehman Brothers and stayed at this appreciated and likely significantly overvalued level until about mid-2012 (see Darvas, 2013a). The strong yen and the desperate Japanese economic situation warranted a new policy approach. A more aggressive monetary policy, including quantitative easing, was the right choice in my view, even though the jury is of course still out concerning its effectiveness.

In the euro area, the European Central Bank should have done more in terms of both conventional monetary policies (reducing the interest rate closer to zero earlier and faster) and unconventional monetary policies (such as a much more significant quantitative easing programme than the two relatively small-scale covered bond purchasing programmes[40]). In 2011, the euro area entered a second-dip recession with weak private demand, strong focus on fiscal consolidation, banks that were vulnerable and unable to grant credit to the economy, and falling inflation. These circumstances made the aggregate economic situation of the euro area very weak, but also made the environment for the necessary intra-euro adjustment much more difficult. And while other major central banks opted for massive quantitative easing, the ECB only implemented the two small programmes mentioned above. This kept the exchange rate of the euro relatively strong, also making it more difficult to adjust intra-

40. Under the first Covered Bond Purchase Programme (CBPP), launched in 2009 and terminated in June 2010, the Eurosystem committed to buy covered bonds up to €60 billion, while in November 2011 the second CBPP commitment was up to €40 billion until October 2012. These CBPPs were not sterilised. On the contrary, the government bonds purchased through the Securities Market Programme (SMP) of the ECB were sterilised, i.e. the same amount of liquidity was absorbed by the ECB and therefore the SMP was not a quantitative easing programme. See Darvas and Merler (2013).

euro imbalances (Darvas, 2012). Therefore, earlier and more forceful action by the European Central Bank would have been justified.

Comment 2: Fiscal adjustment strategies

The second issue I would like to discuss is euro-area fiscal adjustment strategies during the current crisis. In this regard the question has been asked: was fiscal adjustment "*a self-defeating austerity in the face of large fiscal multipliers or indispensable consolidation in a monetary union where some (sovereign) member countries experience balance-of-payments crisis, sudden stops and fiscal limits*"? The way the question was formulated suggests that the answer is the second story. While I cannot agree more that fiscal consolidation was necessary in the vulnerable euro-area member states (though a crucial issue is if it was done too quickly), one cannot correlate the vulnerable member states with the whole euro area. The aggregate fiscal deficit and debt in the euro area is relatively low compared to other advanced economies. Therefore, from an economic point of view, is was not that pressing to pursue a rather rapid fiscal consolidation strategy in the euro area as a whole, at a time when private demand was weak, the cyclical position of the economy worsened and there were major adjustment challenges within the euro area, including intra-euro relative price/wage adjustment (see more on this in my third comment, below) and private sector deleveraging. While I regard fiscal consolidation at an appropriate speed to be inevitable in vulnerable member states, in those euro-area countries that had healthy public sector balance sheets, a fiscal expansion would have been justified (Darvas, 2013b). Proponents of fiscal consolidation used to argue that the European fiscal governance framework limits fiscal policies and changing the framework once again is unrealistic. While agreeing with this point, I would like to highlight that even the options made possible by the European economic governance framework have not been exploited (see Darvas and Vihriälä, 2013).

Comment 3: Low inflation

And thirdly, I would like to make some comments about the low level of inflation, both for Japan in the context of the independence of the Bank of Japan, and for Europe in the context of the dual and conflicting goals of improved price competitiveness and debt sustainability.

Japan faced a period of about two decades with close to zero inflation. Zero inflation was likely the reflection of economic weaknesses. Earlier central bank measures, including quantitative easing, failed to restart inflation. But the country should not give

up its fight against zero inflation: low inflation or deflation makes the sustainability of all kinds of debt more difficult and renders adjustment of relative prices and economic activity across economic sector more problematic. Because of pressure from Mr Abe's government, in January 2013 the Bank of Japan's inflation target was increased from one percent per year to two percent per year, which was seen by several observers as interference with the independence of the Bank of Japan. However, a two percent per year inflation target is not at all extraordinary; such a figure is considered in most advanced countries as the rate of inflation corresponding to price stability. Furthermore, it is the legitimate right of national governments and parliaments to define the target of the central bank. The government is accountable to the parliament, which consists of elected members, while the central bank decision makers are unelected officials. What is important for central bank independence is operational independence, that is, the central bank should be able to decide on its own, without any external interference, on how to meet the inflation target – and should be accountable to the parliament for fulfilling its mandates.

The euro area has unfortunately entered a low inflationary environment: the current aggregate inflation rate of the euro area is close to one percent per year and inflationary expectations, including the forecasts of the ECB, suggest that inflation will stay well below the two percent threshold for many years. Beyond the risk that shocks can push the aggregate euro-area inflation rate below zero when it is low, with all the associated problems, there is a special problem with low aggregate inflation in the euro area: the difficulties it makes for intra-euro rebalancing. Before the crisis, prices and wages grew much faster than productivity in southern euro-area members, while inflation was about or even below productivity growth in core countries, such as Germany. There is now a widespread recognition that these accumulated divergences have to be corrected. This in fact has started, but more is needed. When the average inflation rate in the euro area is low, eg one percent as currently, then inflation in southern euro-area members has to be even lower, eg zero, so that there is a sufficiently high gap relative to German inflation. But low inflation worsens debt sustainability. Therefore, when average euro-area inflation undershoots the two percent threshold, the conflict between intra-euro relative price adjustment and debt sustainability is more severe, as I argued in Darvas (2013c). The ECB should do whatever it takes, within its mandate, to ensure that inflation does not fall below the two percent threshold.

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Part 4:
What policy lessons to draw?

Lessons from the past two decades and a preliminary assessment of 'Abenomics'

KIYOHIKO G. NISHIMURA

1. Introduction

I first draw three important lessons for current and future policymakers from the Japanese and European experiences of the past two decades of so-called credit bubbles and their bursting. The extraordinary characteristics of this recent economic history are lucidly demonstrated by the chapters in this volume both about Japan (around 1990 and thereafter) and Europe (around 2008 and thereafter).

Then, based on these lessons, I present a preliminary assessment of 'Abenomics' and the 'bold' monetary policy of the Bank of Japan. This assessment is indeed very preliminary, since much of the 'beef' of Abenomics is still to come at the time of writing (September 2013). However, this assessment might still be more appropriate than otherwise, since Japanese policymakers have intentionally or unintentionally learned from these lessons drawn from past policy experience (or past policy mistakes, as in Oscar Wilde's famous quote[41]).

2. Three lessons from past experience

Although there are many lessons (or regrets, to be precise) from the past twenty years of policy experience, I would like to pick up three: A, B, and C.

41. *"Experience is the name everyone gives to their mistakes,"* in Oscar Wilde, *Lady Windermere's Fan*, Act III, 1892.

2.1 Avoid wishful thinking – face reality

The first lesson starts with the letter A, which is 'Avoid wishful thinking – face reality'. We have seen overly optimistic forecasts so many times, not only in the so-called bubble period but also in the economic crisis that followed. Wishful thinking is especially damaging in a crisis, since it leads to the behaviour of 'waiting for the return of the old normal', which never comes. This caused substantial delay in the implementation of necessary policy measures.

In fact, there is ample evidence of initial under-estimation of problems that later became large and threatening. The magnitude of the impact of non-performing loans on the economy is the worst example of underestimation and wishful thinking of this kind, which made the balance sheet problems of Japan in the 1990s and the euro area in the 2000s far severer and longer-lasting.

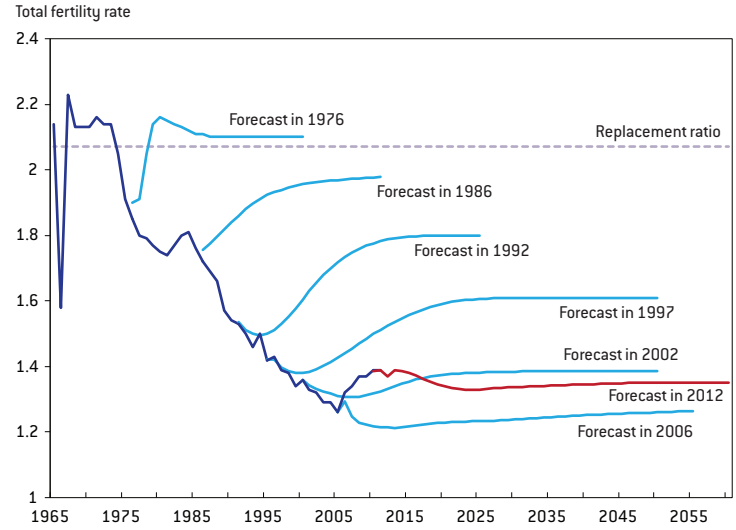
The stubbornness of such wishful thinking is not confined to estimates of non-performing loan, however. It is rather striking to see similar wishful thinking in demographic forecasts. This is particularly problematic in Japan, since the negative impact of unfavourable demographic conditions (ie fewer children and more non-working old people) is one of the underlying causes of the two-decade-long stagnation in domestic demand in Japan. This issue, which is often dubbed population-ageing, should have been given more attention much earlier, and appropriate policies to counter its negative impact should have been devised and implemented much more forcefully.

Figures 1 and 2 illustrate the presence of wishful thinking even in the professional forecasts of demographers. Figure 1 shows the history of revisions of the Japanese total-fertility rate forecast. The dark blue line is the actual fertility rate. The light blue line shows the forecasts made in 1976, 1986, 1992, 1997, 2002 and 2006. The red line shows where we are, that is, the 2012 forecast.

These forecast lines show a clear pattern in which the forecaster thinks the immediate past is not normal and the fertility rate will eventually come back to the normal level. It also shows that demographers have been very slow to learn from the past experience: it takes more than thirty years to 'catch up' to actual declines in the fertility rate. Figure 2 shows the same pattern is found in the life-expectancy forecast.

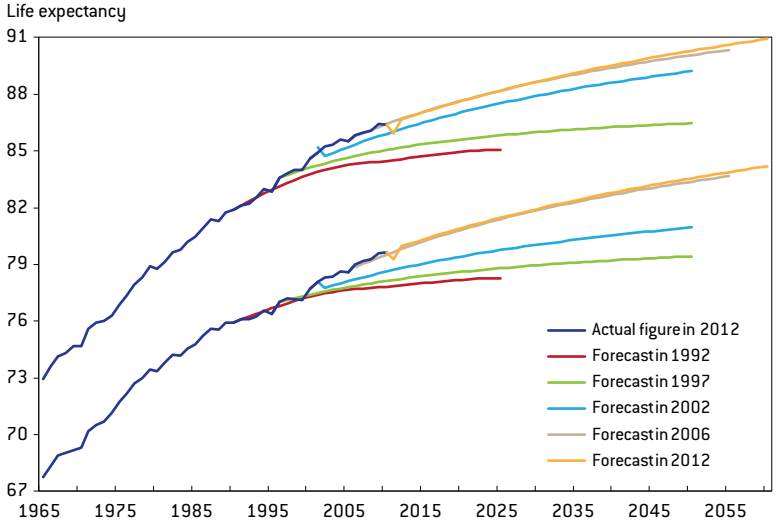
The change in population is slow compared to other determinants of aggregate demand, and is considered to be perfectly forecastable. This is roughly true when we

Figure 1: Revisions to the Japanese total fertility rate forecast



Source: Ministry of Health, Labour and Welfare; National Institute of Population and Social Security Research.

Figure 2: Revisions to the Japanese life expectancy forecast



Source: Ministry of Health, Labour and Welfare; National Institute of Population and Social Security Research.

consider the economy only for the next two to three years. However, it is awfully wrong to assume so for forecasts of next two to three decades, and the price of failure to recognise this problem might be quite sizable, as the Japanese experience of the past forty years suggests.

2.2 Be proactive, not reactive

The second lesson starts with the letter B: 'Be proactive, not reactive'. Policymakers are increasingly under pressure with respect to their accountability, which implies that their policies should be evidence-based. Then, even in the case that policymakers 'sense' sizable changes in the most recent economic conditions (for example, in sentiment surveys), they tend to avoid making decision immediately when available economic data do not show these changes. They do not want to make 'premature' judgments that might induce future criticism[42]. They simply wait and see more data (evidence) to confirm the changes. This might be wise in normal times, but it is not always so in crisis times. Unfortunately, data is often too inaccurate and comes too late as we see in the following example.

Table 1: History of GDP revision (Base year = 2000)

Release	13 Nov	17 Nov	20 May	17 Aug	16 Nov	9 Dec	14 Feb	Final
Date	2007	2008	2009	2009	2009	2010	2011	14 Nov 2011
2007/Q3	2.6	2.3	0.8	-0.4	-2.3	-0.6	-0.9	-1.1
2008/Q3		-0.4	-2.5	-3.9	-6.5	-4.6	-5	-5.2
2009/1Q			-15.2	-11.7	-12.2	-19.9	-20.1	-17.7
2009/2Q				3.7	2.7	11.3	10.8	8.4
2009/3Q					4.8	-1.2	-1.9	-2.3

Source: Cabinet Office. Note: The release date of the quarterly estimate of annualised quarterly GDP growth is shown in the top row, and the left-most column lists the quarter that I would like to examine. It should be noted that the quarterly growth estimate of a particular quarter changes as new raw data flows in and old raw data is revised and new seasonal adjustments are applied. The right-most column is the 'final estimate' of the quarterly growth of GDP (base year = 2000), which was released on 14 November 2011.

Table 1 shows the history of GDP revision in Japan. The release date of the quarterly estimate of annualised quarterly GDP growth is shown in the top row, and the left-most column lists the quarter which I would like to examine. It should be noted that the quarterly growth estimate of a particular quarter changes as new raw data flows in and

42. Policymakers, especially at the central banks, are often subject to the criticism of premature policy change, and thus they are very sensitive to avoid such criticism. See, for example, Mizuno (2006).

old raw data is revised, and as new seasonal adjustment is applied. The right-most column is the 'final estimate' of quarterly GDP growth (base year = 2000), which was published on 14 November 2011.

I pick the key points at which policy action was surely needed: 2007Q3 when the so-called Paribas shock occurred; 2008Q3 when Lehman Brothers collapsed, and 2009Q1 to 2009Q3 where the crisis deepened. Here we see a clear pattern of repeated initial underestimation of the problem. For example, on 13 November 2007, the Japanese Cabinet Office announced its initial annualised quarterly growth estimate of the third quarter (July to September) of 2007, which was 2.6 percent, a quite decent number compared to the Bank of Japan's estimate of the potential growth at that time, which was slightly below 1 percent. Then, ensuing revisions showed a sharp decline in the growth rate, and by 2007Q3 the growth rate had become a large negative number of –2.3 percent when the 2009Q3 data came out on 16 November 2009. A decent growth rate turned out to be a sharp contraction. Although the final estimate (–1.1 percent) was a little higher than the one of 16 November 2009, it was still a large negative. This pattern was repeated in 2008Q3 (from –0.4 percent to –6.5 percent then ending at –5.2 percent) and 2009Q3 (4.8 percent to –2.3 percent). Thus, in these crucial periods, the GDP statistics were not a good guide for economic policy. In particular, the tendency towards initial underestimation was particularly problematic.

I take up GDP figures here for illustration. The same problem is found in many other statistical data, so it is not unique to GDP. The point is that 'current' data might grossly be inadequate or misleading at the time of crisis. They might come too late (because of the considerable time needed to collect and process statistics), might be too inaccurate and might be quite misleading.

2.3 Communicate effectively

The third lesson, which is closely related to the second and the first, is: 'Communicate effectively'. When the economy undergoes deep structural change, the old way of thinking is no longer valid both in the main street and the financial market. Then, the communication policy becomes all the more important to explain the problem we face and the policy we need. Moreover, in the age of information and communication, consumers and investors often show that they are susceptible to herd behaviour, which often leads to excessive optimism on good days and excessive pessimism on bad days[43]. The policymaker needs versatile ability of effective communication to counteract such excess.

43. See for example, Papaioannou *et al* (2013).

This is a difficult task indeed, since it involves issues of credibility. One simple mistake may jeopardise a policymaker's entire credibility. However, at the same time, the policymaker is subject to considerable uncertainty, often facing 'unknown unknowns' (completely unexpected events) rather than 'known unknowns' (forecastable events) at the time of crisis. Then, it is necessary for the policymaker to be flexible enough to adjust to unexpected events. However, such adjustment should not be viewed by the public as a manifestation of the policymaker's inability to control the situation. Thus, communication policy is not simply to announce forecasts and policy intentions. It should also involve careful 'credibility management'.

3. Abenomics and 'bold' monetary policy

3.1 Background: four woes

Before making an assessment of so-called Abenomics, it is necessary to look into its background. There were four woes in the Japanese economy in December 2012, when Abenomics was first presented in the media. They were in fact a series of bad luck, though the last two might be more than that.

The first was the unprecedented real side effects of the global financial crisis triggered by the collapse of Lehman Brothers, especially in 2009, and those of the European sovereign crisis of 2010. Although the direct effects of the financial crisis were much smaller in Japan than in the United States and Europe, the banking crisis had severe contractionary effects on Japanese exports of durables. It should be noted that credit availability has become one of the main determinants of major aggregate demand components such as automobiles and home appliances. Thus, the banking crisis exerted unevenly severe effects on the demand for durable goods, and the machines that are needed to produce such durables. Since Japan was specialised in durable goods manufacturing, the country was hit particularly severely.

The second woe was a series of natural disasters, and accidents that followed. In March 2011, the great northern Japan earthquake hit the country, at the time when the Japanese economy was showing signs of a recovery from the deep recession that followed the global financial crisis of 2009 and the European sovereign debt crisis of 2010. Although reconstruction efforts typically increase economic activity after an earthquake, the great northern Japan earthquake did not, since the tsunami that it triggered caused the nuclear power plant accident in Fukushima, which was the worst event of this kind in the past two decades. This had a devastating effect on consumer sentiment and effectively killed the nascent recovery at that time. Moreover, all nuclear

power plants were shut down because of the public concern for safety, making fossil fuel imports surge and the current account surplus shrink dramatically. The conditions worsened later in the year when the Thai flood of 2011 disrupted the supply chains of Japanese manufacturers, which caused severe supply shortages worldwide and affected exporting companies' profits negatively.

The third woe was the persistent over-valuation of the yen. The yen appreciated considerably from ¥106 to the dollar in June 2008 to ¥77 in December 2011. This duration during which the yen was elevated was unprecedented: The yen stayed in the ¥80s for more than two and a half years. The yen's strength was artificially enhanced by two factors. First, since the dollar and the euro somewhat lost their allure as safe-haven currencies during their financial crisis, the relative attractiveness of the yen was increased because of the relative stability of the Japanese economy and the predictability of economic policy. (The yen was often called a 'safe parking lot'). Second, (especially foreign) investors apparently ignored the magnitude of trade-deficit effects of the nuclear power plant shutdowns. Markets were very slow to recognise the impacts of energy costs on the Japanese current account surplus.

The fourth woe was 'reactive' policies. Unfortunately, Japanese policy making before Abenomics of December 2012 was plagued by inaction, delay and characteristic reactiveness. This was partly due to the political instability that followed the ouster of the Liberal Democratic Party from power in July 2009 at the time of deep economic trouble. The lack of political leadership, or statesmanship, became increasingly apparent both in the ruling and opposing parties in the midst of natural disasters and economic contraction. These observations lead to prevalent pessimism in business and consumer sentiment.

To put it succinctly, November 2011 was the lowest ebb in both economic activities and business and consumer sentiment. It was the right time to make a change.

3.2 Abenomics and 'bold' monetary policy

In essence, Abenomics is the 'three-arrow' promise. The first arrow is 'bold' monetary policy pressuring the Bank of Japan to ease monetary policy substantially; the second is 'flexible' fiscal policy of government expenditure under the name of strengthening social infrastructure; and the third is investment-enhancing structural reform.

The bold monetary policy, including explicit two-percent inflation targeting, was advocated in the election campaign of December 2012. After the election, the newly-

elected Abe government and the Bank of Japan negotiated and issued a joint statement that *"the Bank sets the price stability target at 2 percent in terms of the Consumer Price Index (CPI)"*. The Bank also announced that *"the Bank will pursue monetary easing and aim to achieve this target at the earliest possible time"*.

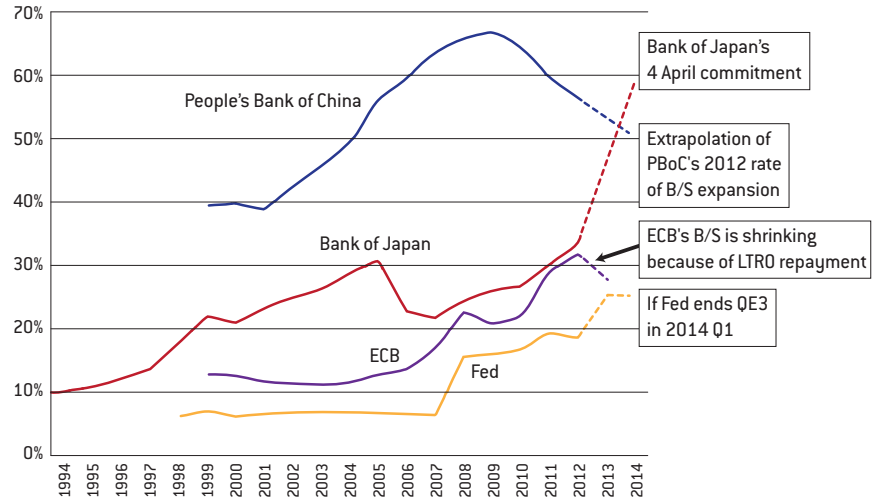
The substantive part, however, of the bold monetary policy of Abenomics was the policy change of 4 April 2013 after the leadership at the Bank had changed. The core of the policy change was *"quantitative and qualitative easing"*, which was succinctly dubbed Q^2 easing. In the quantitative easing part, the Bank promised to double the size of the central bank's balance sheet within one year, through massive purchases of Japanese government bonds. In the qualitative easing part, the Bank promised to more than double its purchase of exchange-traded funds (stocks) and to increase its purchase of Japan real estate investment trusts. The bank also promised to buy Japanese government bonds of substantially longer maturity, and thus to directly influence longer-end government bond markets. The Bank also made the pledge that it would achieve the two percent goal in two years[44].

The magnitude of this Bank of Japan's policy is illustrated by Figures 3 and 4. In Figure 3, the ratio of the central bank's balance sheet to nominal GDP was projected in April 2013 for four central banks: the Federal Reserve, the European Central Bank, the Bank of Japan and the People's Bank of China. The figure is astonishing. The Bank of Japan tripled this ratio in ten years from 1994, and the Fed did in a similar way starting in 2007 in four years. The 4 April decision showed that the Bank of Japan thought the size of the balance sheet was inadequate and would double it decisively in one year. The bank would topple the People's Bank of China in 2014, which had a much less developed financial system and thus greater demand for currency.

Figure 4 shows total government bond issuance and the share of central bank purchases projected again in April 2013. In the first quarter of 2013, the Fed's purchase accounted for 28 percent of the total government bond issuance. This was sizable and stirred controversy because the Fed became a whale in the pond distorting the normal functioning of the financial market, especially with respect to the price finding mechanism of the market. In contrast, the bank of Japan would buy 76 percent of total government bond issuance in the fiscal year 2013. If the Fed is a whale in the pond, then what is the Bank of Japan? It would clearly distort the market and raise a spectre of debt monetisation in several corners of the financial market.

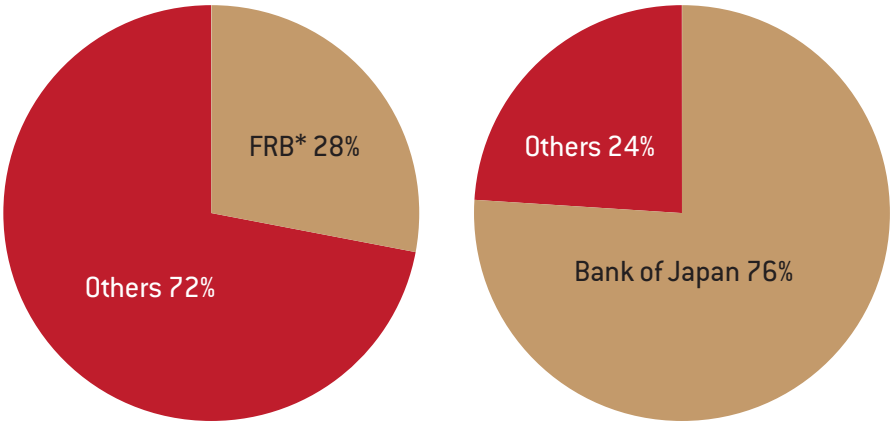
44. The policy change, however, was not innovative, but simply to *"do much, much more"*. In this sense, the phrase used by Governor Kuroda, *"a policy of a different level"*, is appropriate. See Nishimura (2013).

Figure 3: Central banks' balance sheet to nominal GDP ratio projected on 4 April 2013



Source: Totan Research.

Figure 4: Central bank purchases and total government bond issuance, projected at about 4 April 2013



* In the first quarter of 2013, the Fed's purchase accounted for 28% of total government bond issuance

Source: Totan Research.

3.3 Spectacular initial success and mid-year falter

It is fair to say that Abenomics has had a spectacular initial success. It changed the market sentiment or expectations drastically in a way unseen for the past three decades. The sentiment changed almost by one hundred and eighty degrees in the initial five months from December to May, from pessimism to optimism. This was especially the case in news media. People (at least those who were interviewed by the media) once complaining that *"my glass is half empty, and things are not improving"* were instead saying that *"it is half full and things are getting better"*, even though not much had been changed in real terms.

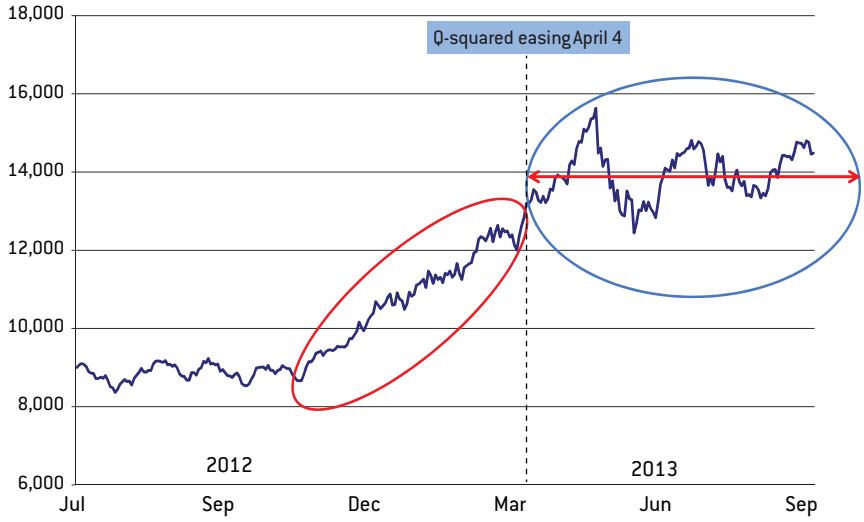
Abenomics was particularly successful in changing the international perception of Japanese politics. For example, one prominent international security expert described Abe as one of three *"true leaders"* remaining in the globe[45]. Thus, the more foreign investors were in the market, the higher the prices were. Foreign exchange and stock markets were a good example of Abenomics's success in changing the behaviour of foreign investors. In contrast, domestic markets for goods and services did not change as much as financial markets.

Perhaps ironically, however, Abenomics's momentum has faded since the Bank of Japan's bold monetary policy was put into full motion. Asset prices were higher, but their volatility increased considerably.

Figure 5 shows the movements of stock prices, the Nikkei 225. The Nikkei climbed from about 9,000 in November to 15,138 on 16 May. However, the market has lost clear upward momentum since then, while volatility has noticeably increased. Figure 6 illustrates the effect of the Bank of Japan's policy change on the 10-year Japanese government bond rate. Abenomics had a sizable effect on the long-term Japanese government bond rate, which was the most important reference rate showing investors' assessment of financial market conditions. From about 0.75 percent, this risk-free rate went down all the way to below 0.5 percent. However, after the policy change of 4 April, it shot up to 0.9 percent and became very volatile, though its level went down and volatility has decreased somewhat since then.

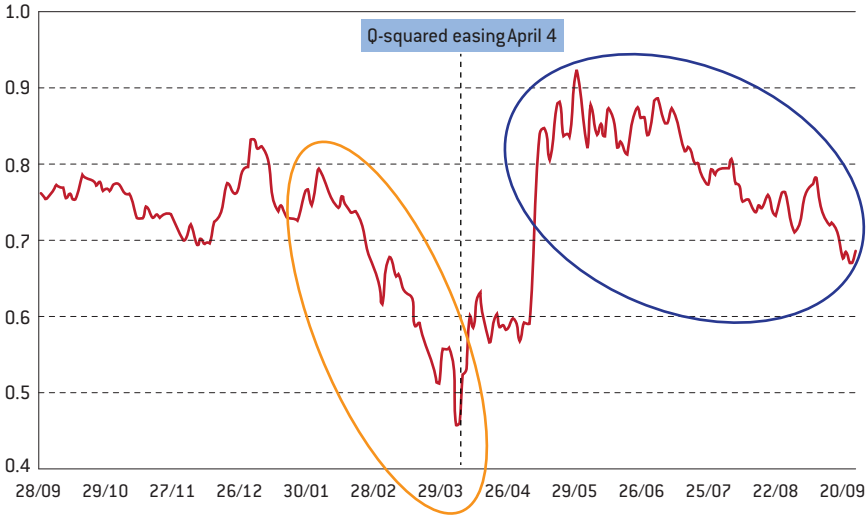
45. Ian Bremmer (2013).

Figure 5: Stock markets: Nikkei 225



Source: Tokyo Stock Exchange.

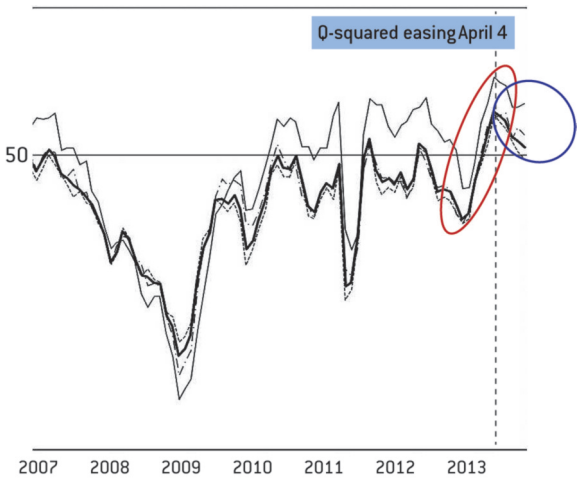
Figure 6: Bond markets: 10-Year Japanese government bond rate



Source: Japan Bond Trading Co., Ltd.

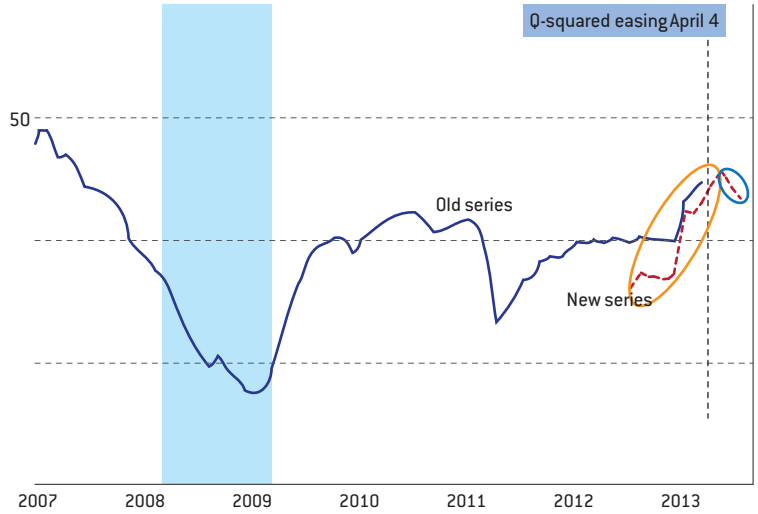
A similar story is found in the real economy, especially in business and consumer sentiment surveys. Figure 7 shows the movement of the sentiment indices of the Economy Watchers Survey, which is known for a high correlation with GDP growth. This is a survey of those who have close contacts with firms and consumers, such as taxi drivers, recruiting agencies and so on. Although it is not a statistically designed survey, it has a good track record with respect to GDP growth, and it is almost concurrently available with only a short lag. In Figure 7, both business and consumer sentiment indices improved and moved up until April (the Bank of Japan's policy change) and then lost upward momentum, stalling from May to August. Figure 8 shows the change in consumer confidence in the Consumer Confidence Survey, where the blue zone indicates recession. Consumer confidence moved up until May, and then stalled from June to August.

Figure 7: Economy Watchers Survey



Source: Economic Watchers Survey, Cabinet Office.

Figure 8: Consumer Confidence Survey



Source: Consumer Confidence Survey, Cabinet Office.

4. Recapitulation and a preliminary assessment of Abenomics

In this section, I first revisit the findings in section 3 and then present a preliminary assessment of Abenomics based on the three lessons in section 2.

Abenomics had a spectacular initial success in changing the nation's mood, which particularly mattered in politics. Prime minister Abe apparently learned at least partly from the lessons I outlined in section 2. In particular, Abenomics was proactive, not reactive. Abenomics was considered to be a bold, decisive policy initiative, not reacting to ever-changing, noisy current conditions, but proactively acting for future secular change. Moreover, the prime minister's communication policy was impressively successful in convincing firms and consumers that a better future was ahead of them, or at least that the worst was over.

The upward momentum of Abenomics, however, faded after the Bank of Japan's so-called bold policy change, in both financial markets and real economy, while volatility increased substantially in financial markets. This is somewhat ironic, since the policy change was intended to put Abenomics in full motion. In fact, the policy change was really daring and surprised even those who anticipated an about-face in the policy

stance, which was once described as financially incremental and a return to the incremental policy of the past. But unfortunately, it also increased uncertainty substantially about future monetary policy and financial conditions, especially with respect to future long-term rates and long-term inflation. The Bank did not explain its view about these issues, and even refused to do so, saying that it was premature[46]. Thus, it was no wonder that the markets became volatile and business and consumer confidence faltered in the face of greater uncertainty.

There are two lingering questions to be answered forcefully by the Bank of Japan. First, how can the bank raise inflationary expectations substantially in two years, even though most market participants remain skeptical? Second, suppose that the Bank is successful in achieving the two percent in two years goal. Then, what financial conditions, especially long-term government bond rates, are to be expected in two years from now?

It is unfortunately the case that the Bank of Japan failed to recognise two of the important lessons from the past that I have detailed in section 2. The bank clearly needs a persuasive communication policy to show to the public where it is heading and what kind of contingent plans it has in the case unfavourable conditions emerge. Above all, the bank has to show it is free from wishful thinking, by presenting forceful arguments and supporting data to show that the two percent in two years goal is in fact achievable.

A careful observer of the Japanese consumer price index understands that the past deflation is the result of the prolonged below-normal economic activity of the past several years, and that when the economy picks up, one percent inflation is achievable in one to two years[47]. After all, long-run inflationary expectations have been stable at one percent for more than a decade. However, to raise these inflationary expectations by one more percent is a different matter altogether. So far, the bank maintains the position that their firm determination of the two percent goal is sufficient to raise long-term inflationary expectations. One critic aptly dubs this position a psychokinetic theory of inflationary expectations[48]. Certainly we need more explanation on this matter.

46. he importance of explanation of future policy is forcefully emphasised by Kohn, former vice chair of the Board of the Federal Reserve System. See Kohn (2013).
47. A series of unexpected negative shocks (global financial crisis, earthquake, nuclear power accident and so on) caused the prolonged below-normal economic activities, as I explained in section 2.
48. See: http://ikedanobuo.livedoor.biz/archives/51869937.html.

Abenomics' faded momentum so far is partly due to the return of uncertainty about the future, not only about monetary policy but also fiscal policy and structural reform. As it stands now, Abenomics is largely still a promise, especially with respect to its most important 'third arrow' of (investment-enhancing) structural reform. Moreover, there is fear among people both in the street and the financial markets that temporary loosening of fiscal consolidation may turn out to be permanent, and thus eventually lead to debt monetisation[49].

Here, there is a pressing need to show that the prime minister is free from wishful thinking and that he is an effective communicator as well. He should explain: what structural reform will the Abe government implement, which is effective to raise growth potential (investment) and to counteract population ageing (labour)? Also he should elucidate: what is the road map of the financial consolidation, which is bold to be effective and realistic to be persuasive?

Concluding remarks

To conclude, I would like to emphasise that there is a good chance of ultimate success for Abenomics. First, and above all, the Japanese economy is in a natural recovery phase from prolonged below-normal economic activity caused by a series of unexpected negative shocks such as the Fukushima nuclear power plant accident. And so far, there is no additional bad luck, and we see some good luck such as the 2020 Olympic Games in Tokyo. Secondly, the public still has a favourable perception of the Abe cabinet and its economic policy, which brings political stability.

It is, however, absolutely necessary for ultimate success to learn from three lessons of the past, as described in Section 1, summarised in three dicta: avoid wishful thinking, be proactive and communicate effectively. Moreover, economic and political conditions are dynamic and full of unknown unknowns. In such dynamic conditions, the policymaker should be flexible enough to follow these three dicta, and be able to show that the three dicta are being followed. Avoid hubris, to say the least.

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49. 'Nichigin ijigen kanwa wa zaisei-fainansu ka? (Is the Bank of Japan's super easing debt monetisation?)' (2013) *Reuters*, 16 April, available at http://jp.reuters.com/article/vcJPboj/idJPTYE93F06620130416

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Japan and the EU in the global economy – challenges and opportunities

PETER PRAET[50]

Since the beginning of the financial crisis, there has been no shortage of challenges along the road back to what I would call the 'normal functioning' of our economies. One of the biggest challenges is still to be addressed: that of how to grow in an era of deleveraging. Deleveraging can occur in an orderly fashion or it can be chaotic. It may drag our economies down or it can place them on a stronger footing. Which of these will be the case depends to a great extent on how we manage the process.

As witnessed in Japan, protracted and large-scale balance sheet adjustments can weaken economic activity over a protracted period. Repairing the financial sector was an important element in improving the Japanese economy. The lesson for the euro area appears to be clear: the overhaul of the financial architecture – including the establishment of a procedure for resolving failing banks – needs to be accomplished in its entirety; selective mending will not be enough. We should make use of the momentum offered by the crisis to turn these challenges into opportunities – opportunities to put our economies on a sounder footing.

Imbalances in Japan and the euro area

The Japanese experience provides important lessons because it demonstrates the difficulties of emerging from a 'balance sheet recession'[51]. With the euro area still

50. I would like to thank Stephan Fahr, Georgi Krustev and Ana Lima for their contributions; all views expressed remain my own.

battling the impact of the financial crisis, an important question is: how does the current euro-area economy compare with the dynamics in Japan during the 1990s[52]?

Both episodes clearly share elements of a 'balance sheet recession', in which strong credit expansion ends with a sharp correction in asset prices, thereby triggering the need for significant balance-sheet adjustment.

Yet, the scope of the required adjustment in the euro area when viewed at the aggregate level differs markedly from that in Japan, even if some euro-area countries struggle with excessive leverage.

In Japan, the sharp fall in equity prices from the 1989 peak led to losses of almost 80 percent in the two decades that followed. Real estate prices also tumbled, with urban land prices declining by about 40 percent. By comparison, at the euro-area aggregate level, equity prices fell by about 50 percent and have already rebounded from their post-Lehman trough, while residential property prices have fallen by a mere 3 percent since their peak in 2008.

Moreover, the levels of indebtedness across sectors clearly differ. As for fiscal imbalances, the fiscal response in Japan meant an increase in public debt from 67 percent of GDP at the start of the 1990s to about 240 percent in 2012. For the euro area as a whole, the increase was much smaller, with aggregate debt increasing from below 70 percent in 2008 to 92 percent in 2012. Obviously, the euro-area aggregate figures mask the significant heterogeneity between member states, with gross debt ranging from 10 percent of GDP in Estonia to 157 percent in Greece. That notwithstanding, it goes without saying that general debt levels in European countries need to decline, also because of long-term demographic challenges.

Turning to private sector debt, Japan faced severe adjustment needs in the corporate sector, with debt of non-financial corporations declining from 130 percent to 80 percent of GDP in the 15 years that followed the peak in economic activity. In the euro area, the debt level of the aggregate non-financial sector never reached the peaks seen in Japan and aggregate household indebtedness is also comparatively lower in the euro area. However, in those euro-area countries that experienced housing bubbles, the household sectors have been facing much greater adjustment problems. Here, again,

51. As termed by Richard Koo (2009) *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*, Wiley.
52. See also ECB (2012) 'Comparing the recent financial crisis in the United States and the euro area with the experience of Japan in the 1990s', *Monthly Bulletin*, May.

euro-area averages mask significant heterogeneity between member states.

In fact, some euro-area countries have seen strong capital inflows and unsustainable debt-financed economic expansion. This has not only brought the risk of reversal, as seen after 2008 when private capital inflows dried up and domestic demand collapsed, it has also led to economic divergence within the euro area. Some countries have lost heavily in terms of competitiveness relative to their peer euro-area countries. Regaining this competitiveness will indeed be a more gradual and tedious process[53].

The credit-financed housing boom in countries such as Ireland and Spain led to residential property prices more than doubling in the seven years leading up to their peak. Since the peak, adjustments in house prices appear to have been completed in Ireland, while those in Spain are correcting more gradually. In both cases, the house price boom has left household debt-to-income ratios far above their pre-crisis levels with only a slow decline.

To summarise, while euro-area aggregate dynamics appear different from those observed in Japan at the beginning of the 1990s, some euro-area countries do share some features that are very similar to the Japanese experience in that a prolonged balance-sheet adjustment is underway.

Notwithstanding this cross-country heterogeneity, a common response was required from monetary policy in the euro area to counter the initial fallout. The cuts in European Central Bank policy rates together with non-standard measures were crucial to contain the risks to price stability and to support the transmission of monetary policy across the currency area. While common monetary policy has been successful, the crisis has shown that we need more solid common institutions in other policy areas. In particular, a common monetary policy requires a common regulatory framework for the financial sector to be able to adequately repair the financial system, thereby securing a durable recovery in the euro area. The adverse impact of 'zombie banks' and the evergreening of loans in Japan serve as a stark warning signal.

Given the challenges ahead, we should not relax our efforts to put the euro-area

53. Of course, in a financially integrated area comprising several countries, financial deficits (or surpluses) of a given sector in any country can, in principle, be financed (or invested) equally well in any other country within the area. Following this line of reasoning, cross-country patterns in sectoral financial balances could reflect increased financial integration within the euro area. At the same time, the build-up of external deficits and surpluses in different euro-area countries reflects not only growth differentials, but also rising imbalances in competitiveness, particularly when measured by unit labour costs.

economies on track to strong and sustainable growth. That way, we can turn the current challenges into opportunities. Further managing the deleveraging process will be key, especially balancing the speed of adjustment and reforming euro-area governance. Let me elaborate on these two aspects in turn.

Managing the deleveraging process

To overcome debt overhangs, there are basically two options: consolidate or restructure debt to address the nominal debt stock; or implement growth-enhancing structural reforms that make our economies fitter to grow out of the debt burden. Or a combination of both can be pursued. A third theoretically possible option allowing for higher inflation to reduce the real value of the debt would go against the core mandate of central banks.

In recent years, we have seen some consolidation in Europe. In terms of public finances, euro-area fiscal deficits exceeded 6 percent at the peak of the crisis in 2009 and 2010, but are expected to fall below 3 percent in 2013, while primary budgets are even expected to post a surplus of 0.2 percent[54]. This adjustment strategy has brought with it painful cuts to our social models and has not been without controversy.

In fact, some commentators and academics suggest that governments should continue increasing deficits to support aggregate demand while the private sector is deleveraging. They argue that parts of the private sector are debt-constrained and need to reduce their leverage, while parts that are unconstrained are not increasing their leverage sufficiently[55]. In such an environment, the role for government spending is to expand demand for funds, and especially so when the nominal interest rate is constrained by the zero lower bound[56]. I would agree with this approach if the fiscal budget allowed for room for manoeuvre. But the recent sovereign debt crisis has shown that fiscal space is very limited for many European countries.

In Japan, the strategy of fiscal expansion has led to a situation in which gross government debt levels now exceed 200 percent of GDP. The continued favourable financing conditions appear to also be down to the fact that more than 90 percent of

54. Fiscal deficits in the euro area reached 6.4 percent of GDP in 2009 and 6.2 percent in 2010 (according to Eurostat). The European Commission forecasts -2.9 percent in its Spring 2013 European Economic Forecast.
55. See Eggertsson, G. and P. Krugman (2012) 'Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo Approach', *Quarterly Journal of Economics,* 127 (3): 1469-1513, and Guerrieri, V. and G. Lorenzoni (2011) 'Credit Crises, Precautionary Savings, and the Liquidity Trap', *NBER Working Papers*, No 17583.
56. See also the series on deleveraging by Martin Wolf in the *Financial Times*, starting with 'We still have that sinking feeling', *Financial Times*, 10 July 2012, and 'Ways to accelerate private-sector deleveraging', 30 July 2012.

Japanese government bonds are held domestically. This situation can be seen as a special privilege for the government. But the high exposure of banks to their domestic sovereign – in fact, Japanese banks hold about 20 percent of their assets in domestic sovereign bonds – is not without risks, especially in the event of sudden reversals in market confidence. Maintaining financial and economic stability therefore requires a clear and long-term fiscal strategy to avoid disruptions. This is true for Japan and Europe alike.

Debt consolidation is not limited to the public sector, however; it also applies to areas of the private sector with excess leverage. While in the euro area the ratio of financial sector liabilities to GDP has broadly stabilised, euro-area large and complex banking groups have steadily increased the median core Tier 1 ratio from 8.3 percent in 2009 to above 11 percent in 2013[57].

To strengthen their capital position, banks have issued equity, converted hybrids, received capital injections and raised the levels of retained earnings. The stronger capital positions also mean that the relative share of debt in financing is reduced and substituted by more equity, which should provide a better buffer against economic shocks. After all, debt is a relatively inflexible form of financing because it requires repayments on time and in full.

But the stronger capital positions have also meant that banks have been shedding assets, a process that depresses credit growth and puts a drag on the economy. In addition, as households and non-financial corporations also reduce their indebtedness, they are demanding less financing from banks. Taken together, we can expect that bloated balance sheets will contract further.

It is important that this deleveraging process occurs in an orderly manner by balancing the adjustment of assets and liabilities. Most of all, unnecessary fire sales generating detrimental falls in asset prices and credit rationing for productive investments need to be avoided. Throughout the crisis, the ECB has demonstrated its ability to actively mitigate these effects by ensuring abundant funding to the banking sector through its liquidity operations. But more is needed, especially regarding a more solid institutional framework to repair balance sheets in a way that limits systemic risk and avoids damage to the real economy.

The Japanese experience has shown the risks that arise when banks' balance sheet

57. See ECB, *Financial Stability Review*, May 2013.

problems are not recognised and addressed. Weakly capitalised banks initially extended loans to insolvent firms to limit the recognition of losses in the short run. Indications of evergreening became prominent as the share of loans to the construction sector continued rising for years after the bubble had burst, despite the fact that this sector was adjusting and needed to downsize. Write-offs on non-performing loans and necessary recapitalisations were delayed and the financial sector remained highly vulnerable to shocks. But delayed recognition was also facilitated by valuation standards that did not mark non-performing loans to market, unlike much of the losses from securitised products in the recent crises. In addition, the refusal of banks to foreclose on borrowers might have reflected a different resolution culture and code of civility in Japan; namely, one that eschews the large turnover of jobs and the frequent discharging of workers and avoids inducing a humiliating 'loss of face' for delinquent borrowers[58].

For the real economy, the ever-greening of loans implied a weakening of growth prospects[59]. Potentially more efficient enterprises were denied financing, thereby hampering the natural entry and exit of firms into and out of the market place. Indeed, with the recession in Japan at the beginning of the 1990s, entry rates of firms declined from their pre-crisis peak of above 7 percent to a range of 4-5 percent, whereas firm exit rates remained subdued at their pre-crisis levels throughout the 1990s[60].

The lesson from this experience is to recognise non-performing loans in a timely manner and have strong institutions in place to deal with the restructuring. This reduces uncertainty and avoids adjustment delays. For the euro area, it is a call to move forward in completing the banking union.

Supervision and resolution

Up until now, supervisory and resolution authorities have operated at the national level. During the crisis, this set-up has exhibited shortcomings on three fronts. First, differences in supervision maintain humps and hollows in the euro-area playing field,

58. On this point, see Greenspan, A. (2007) *The Age of Turbulence: Adventures in a New World,* Penguin, pp. 289-290.
59. See, for instance, Caballero, R., T. Hoshi and A. Kashyap (2008) 'Zombie lending and depressed restructuring in Japan', *American Economic Review*, Vol. 95: 1943-1977; Peek, J. and E. Rosengren (2005) 'Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan', *American Economic Review*, 95: 1144-1166; and Nishimura, K.G. and Y. Kawamoto (2003) 'Why does the problem persist? "Rational Rigidity" and the plight of Japanese banks', *The World Economy*, Vol. 26: 301-324.
60. Entries of business establishments declined from their peak of 7.4 percent in 1988 and have not exceeded 5.0 percent since then, whereas exit rates remained at subdued levels of 2.5-4.0 percent between 1988 and 2000 and have increased to above 4.0 percent since then.

thereby distorting competition; second, differences in implicit state guarantees affect banks' funding conditions; and third, differences in resolution frameworks – or a lack thereof – distort investor conditions across jurisdictions.

The envisaged European banking union is meant to address these three problems.

First, the single supervisory mechanism (SSM) will level the playing field in supervision. The ECB will take over supervision of euro-area banks in the second half of 2014.

We will ensure that euro-area banks are supervised in a consistent and stringent manner. This implies impartial supervisory decisions across all member states. We are already in the midst of preparations that will form the basis for a stress test to be carried out by the European Banking Authority in close collaboration with the ECB. In order to achieve its goal, this review needs to be rigorous and stringent. For it to be credible, we need commitment on sound backstops as a fall-back option for fulfilling capital needs.

In Japan, such a close inspection of bank balance sheets was carried out in 2002. It proved to be an important step to recognising losses and cleaning balance sheets to eventually set off a gradual recovery with credit expansion in Japan.

Second, one of the objectives of a European banking union is to delink banks from their sovereigns. That also implies that bank funding costs will depend on the quality of banks' assets, and not on the location of their headquarters. Achieving this would mark a milestone in that it would establish a single capital market throughout Europe that companies can tap into. A single capital market, in turn, provides better financing for companies and eases productive investment, which will revitalise the European economies. Ultimately, it will be decisive in ensuring that Europe avoids a repeat of Japan's 'lost decade', during which zombie banks poorly allocated financing to firms.

Third, orderly deleveraging in the euro area also requires that the restructuring and resolution of individual banks will not endanger financial stability or put public finances at risk. For this, the institutional framework needs to be solid. This is the rationale behind the creation of a single system with a single resolution authority and single resolution fund, in line with the proposal by the European Commission for a single resolution mechanism. The resolution fund is to be entirely financed *ex ante* by the financial industry itself in order to protect the European taxpayer. Still, until the fund is fully built up or for exceptional circumstances, it should be able to obtain external

funds via a backstop. Here, the feasibility of a credit line from the European Stability Mechanism could be explored. Any such backstop should be temporary in nature and compensated by *ex-post* levies on the banking sector, ensuring that the fund is fiscally neutral over the medium term.

A banking union with these elements in place has the potential to delink banks and sovereigns, not least by following an important principle: bail-in precedes bail-out. This will ensure that shareholders and unsecured creditors according to the hierarchy of their claims are the first to bear losses, not the taxpayers.

Monetary policy

Speaking in my capacity as a central banker, let me finally come to the role of monetary policy in the deleveraging process.

To counter the risks from disorderly deleveraging, the swift cuts in ECB policy rates and our non-standard measures were key. Fixed-rate full allotment and longer-term refinancing operations stabilised financial markets early on and counteracted the risks from fire sales by providing liquidity where it was most needed.

Equally, the ECB did not shy away from bold measures to curtail tail risks and to restore the monetary policy transmission. During 2013 euro-area financial fragmentation has reduced significantly, capital flows reverted to stressed countries and financing costs for corporates converged somewhat in different countries.

These measures had the overarching purpose of ensuring price stability over the medium term. For the euro area, this is not merely lip service to the primary objective stated in the EU Treaty. It is, instead, the yardstick against which to measure the success of the ECB policies and to build credibility. In fact, inflation expectations remained firmly anchored throughout the crisis. By contrast, policy interest rates in Japan in the early 1990s remained at higher levels for longer, which, together with a lack of reforms in other areas, contributed to protracted economic weakness and falling prices. Eventually, inflation expectations became unanchored and made stabilisation more difficult for monetary policy once it was at the zero lower bound.

Some commentators would go further and argue that central banks should loosen the belt in the deleveraging process to actively stoke high inflation[61]. I disagree with this line of reasoning. Although surprise inflation would reduce the real debt burden in the short run, it would sow doubts about the central banks' ability and willingness to control

inflation in the longer run. Ultimately, it would undermine efforts to implement structural changes and prudent policies.

However, as the Japanese experience has shown, monetary policy alone cannot place the economy on a sustainable growth track. Bold monetary policy measures may be effective in the short run, but they also bear the risk of reducing incentives for banks to restructure balance sheets. We are aware of these risks.

Furthermore, even if central banks operate within their own specific circumstances and mandates, the policy measures may lead to unintended spillovers to other countries. To ensure that monetary policy is transmitted adequately to the economy and domestic financing conditions are insulated from those prevailing in the global economy, sound macroeconomic policies and strong domestic institutions are vital.

In addition, to place the economy back on track to sustainable growth, a medium-term fiscal consolidation strategy as well as structural reforms with productive investment are essential; these two elements combined with monetary policy form the three arrows identified by prime minister Shinzo Abe. Monetary policy can buy time to implement structural changes and ease the deleveraging process, but it cannot cure the root causes of imbalances or be a substitute for structural reforms.

Conclusion

Both the euro-area and Japanese economies face major challenges to counter the risks from deleveraging. Preventing disorderly deleveraging will remain key to limiting possible adverse effects on the economic performance in the most indebted euro-area countries. At the same time, repairing banks' balance sheets and ensuring their soundness is a pre-condition for re-establishing adequate financing of the economy. This is why the SSM, including the comprehensive assessment, and the single resolution mechanism, are crucial steps towards improving euro-area governance. The European institutional context may sometimes appear cumbersome, but the progress made shows that Europe recognises problems and responds to them.

Nevertheless, even with these changes, solving a stock problem means addressing a prolonged adjustment in flows in the future. We are all well aware that debt consolidation alone weighs on economic activity just like a diet leaves one with the

61. See, for example, Blanchard, O., G. Dell'Ariccia and P. Mauro (2010) 'Rethinking Macroeconomic Policy', *Journal of Money, Credit and Banking*, 42(s1): 199-215.

feeling of fatigue. The deleveraging process will require time; we should not lose patience in the process.

Compared with past episodes, deleveraging has, in fact, become even more challenging. The global dimension of deleveraging makes burden-shifting across countries impossible and today's demographic trends are placing a strain on our growth prospects. It is therefore crucial to balance the consolidation across generations[62].

Nonetheless, the need to complement the consolidation process with structural changes in order to make our economies fitter should be reemphasised. This involves reducing red tape to ease business creation, streamlining governance of state-owned enterprises and reallocating workers more flexibly from stagnating and declining industries to productive and expanding ones. Structural reforms are not only required in the countries in the euro area, but have also been recognised by prime minister Abe in his third arrow as essential to securing the Japanese recovery over the long term.

62. See, for example, Tokuoka, K. (2012) 'Intergenerational Implications of Fiscal Consolidation in Japan', *IMF Working Papers*, 12/197.

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Bruegel is a European think tank devoted to international economics. It started operations in Brussels in 2005 as a Belgian non-profit international organisation supported by European governments and leading corporations. Bruegel seeks to contribute to the quality of economic policymaking in Europe through open, facts-based and policy-relevant research, analysis and discussion.

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Japan and the European Union in the global economy

Japan and the European Union are open economies with significant trade and financial links. Both are affected by the rise of emerging markets, which represent a huge opportunity but also imply the need to continuously adapt the production structure to the new competition. Both economies also face comparable internal economic adjustments. Japan, where it took years to resolve the problems that arose in the banking sector in the 1990s, is pursuing the so-called 'Abenomics' strategy to overcome deflation, re-invigorate economic growth and increase productivity growth rates. Europe, meanwhile, continues to struggle with the effects of severe crisis, with similar balance-sheet adjustments happening in some parts of its economy. In Europe as in Japan, the role of monetary policy and banking policy is hotly debated, and the appropriate role of fiscal policy and structural reform is controversial in both economies.

This volume sets out to address these issues, and to identify some of the channels through which Europe can learn from Japan, and vice versa. It is the final output of a strategic European Union-Japan research partnership, involving Kobe University and Bruegel with selected outside contributors from Japanese and European government and policy institutions.

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