

Example Masters Economics Essay

“It is not surprising that monetary and fiscal policies have failed to produce sustained recovery in Japan. The origins of stagnation were on the supply side” Do you agree?

From the bursting of the stock and land price bubble in 1990, the Japanese economy has been stagnating in a low growth, disinflationary state. Growth has averaged 1.5% for the period 1991-2000 compared to 4% for the period 1979-1990, and has been negative or virtually so between 1998 and 2002 (bar 2000 where it was 2.8%). Inflation has been negative since 1995, and greater than -1% since 2000. Even the Japanese unemployment ratio has doubled over the period, and exceeded the USA's for the first time post war in 1999. Since a widespread and prolonged stagnation must have deeper explanations than merely a burst bubble for its persistence, the question infers that the problems are structural on the supply side, and that this is the reason neither monetary or fiscal policy efforts have been able to produce a recovery. First then I will analyse Japanese fiscal and monetary policies in this period, and then analyse the competing explanations of the stagnation picture, to evaluate if they can explain Japan's inability to extract itself from the 'lost decade'.

Japanese fiscal policy was initially slow to respond to the burst bubble, but in 1993 a series of 'special' tax cuts were introduced, combined with cash injections to the failing Jusen financial institutions. These tax cuts were successful to a certain extent, and the Japanese economy is considered to have been recovering between 1995 and 1997, but the repeal of these tax cuts brought about an abrupt halt to this recovery. Post 1997 expansionary fiscal policies have continued, and Japan now has a budget deficit of 6% of GDP. Recent fiscal policy has been marginally successful – Japan began growing significantly again in 2003, but it would go too far to suggest they have produced sustained recovery. An expansionary monetary policy was pursued aggressively post 1992, with interest rates falling to near zero by 1994. However monetary policy has had little success, partly it seems as Japan has been caught in a liquidity trap. In a liquidity trap the money supply can no longer be expanded, as to do this would require a negative nominal interest rate. This is impossible as then money would dominate bonds as an asset. Therefore any

monetary expansion beyond that consistent with a zero nominal interest rate is merely substituted for zero interest bonds, with no effect on output and prices. Both Krugman and Posen argue that this is the situation Japan has found itself in.

There are three major explanations for the state of the Japanese economy. The supply side explanation argues that both Japan's demographics and its labour market model are ill suited to fast growth in the current climate. Kashimaki argues that Japanese growth potential is no greater than 2% per annum, and that the experience of the 1990's is explicable as Japan adjusting to a low growth future. Japan's ageing population issue is both cutting Japan's aggregate savings rate and more importantly reducing its labour force-population ratio and thus reducing its labour productivity growth potential. Further Kashimaki also argues that the Japanese business model is outmoded and unsuited to taking advantage of the ICT revolution and new economy emanating from America. Monetary and fiscal policy then cannot produce a sustained recovery as the low growth nature of Japan is a structural not economic problem. Fiscal policies' potency is further constrained by the demographics problem in that pension and health expenditure is rising with falling tax contributions, reducing the scope for fiscal manoeuvre.