
Over the last decade the study of Japan's economy has become quite fashionable among economists outside Japan. One of the main barriers to entry for most Western economists is an inability to read Japanese, which severely restricts access to the literature. In light of this constraint, this collection of papers is particularly valuable because it provides a nice English language survey on the conduct and consequences of Japanese monetary policy. The strength of these six essays is their systematic attempt to contrast Japanese institutions and stylized facts with institutional arrangements and empirical regularities in other countries - primarily the United States. By linking the analysis to the literature on the impact and operation of monetary policy in other countries, the authors have produced a book that should be of lasting importance.

The book has two distinct parts. The first two chapters describe the operating procedures of Japanese monetary policy. The remaining four chapters discuss the monetary policy transmission mechanism. While these themes are probably the two most important topics to students of monetary policy, there is a host of issues that also deserve attention. For instance, as Singleton notes in his introduction, none of the papers in this volume discusses the role of monetary policy in the rapid asset price inflation and disinflation of the late 1980s and early 1990s. Since any evaluation of the success of Japanese monetary policy during this period would depend critically on whether one views these events as having been caused by shifts in monetary policy, the absence of any discussion of this issue is unfortunate. A second topic that is neglected (and as the subsequent discussion will show is quite important) is the impact of the recent financial market deregulation. Indeed, my principal disappointment with the book is that it does not cover more topics. But aside from this error of omission, this is a good book and the material that is included is well worth reading if one wants to study Japanese monetary policy.

In terms of specifics, the book begins with Kazuo Ueda's depiction of the Bank of Japan's (BoJ) modus operandi. The paper starts with a quick comparison of U.S. and Japanese operating procedures. Following this review, Ueda argues that the BoJ has essentially always relied on interest rate targeting. To buttress this position, he presents evidence showing that interbank interest rates in Japan are much more stable than in the United States - even when one excludes the controversial period in the early 1980s when the Federal Reserve was alleged to have abandoned interest rate targeting in favor of reserve targeting.

The main implication of the decision to target interest rates is that the
money supply becomes endogenous – a shift in banks' demand for reserves must be fully accommodated if the BoJ insists on pegging the interest rate. Because of this endogeneity, identifying exogenous shifts in monetary policy from changes in monetary aggregates will be difficult. Understanding this identification problem is important for reconciling some of the differences that are reported in the other papers in the volume (Yoshikawa and West) that seek to quantify the importance of changes in the stance of monetary policy.

In chapter 2, Kunio Okina (a BoJ staff member) offers a complementary, but slightly different view of how the BoJ operates. Okina also believes that 'the Bank of Japan's monetary policy always begins with controlling interest rates in the short-term money market'. However, he stresses the importance of accounting for the regulations that govern reserve requirements. Japanese banks' required reserves are determined partially on the basis of deposits held in the two weeks before the reserve maintenance period begins. Because of this so-called lagged reserve accounting system, the demand for reserves is predetermined by the end of a reserve maintenance period. This fixity of required reserves, combined with stiff penalties for failing to satisfy reserve requirements, means that banks' demand for reserves is very insensitive to interest rates at the end of the reserve maintenance period. The BoJ can take advantage of this need and determine the interbank interest rate by buying and selling reserves at a target rate. Once the rate is credibly established for the last day of the maintenance period, intertemporal arbitrage forces the interest rate to hold throughout the remainder of the period.

While this description is somewhat more complete than Ueda's, fundamentally both papers suggest the same basic mechanism. The other synergy between the two papers is that rather than contrasting Japan's money markets with other countries, Okina provides a very detailed description of the regulations and institutional norms that apply in Japan. Therefore, together the two papers present a concise description of how the instruments of monetary policy are deployed in Japan.

The remaining four chapters in the book take up the more controversial subject of how monetary policy affects the economy. The first of these papers, by Takeo Hoshi, David Scharfstein and Kenneth Singleton (hereafter HSS), examines the importance of the BoJ's efforts to directly control credit extension to business. This so-called 'window guidance' historically took many forms, but generally involved the BoJ pressuring major financial institutions to reduce lending during periods when the Bank was tightening monetary policy. HSS study both aggregate and firm-level data to determine the importance of lending contractions.

Using aggregate data, HSS find that during periods of considerable BoJ pressure, lending by financial institutions that were subject to window
guidance declined while credit extended by institutions not subject to controls (e.g. insurance companies) rose. This change in the 'mix' of external financing suggests that firms actively attempted to offset the decline in bank lending. This, in turn, suggests that the declines in bank borrowing that follow periods of window guidance do not occur solely because of reduced credit demand. Following this reasoning, HSS use their mix variable as a proxy for window guidance and study the correlation between the mix and business investment. They find that the window guidance proxy has some significant explanatory power for fixed investment even when one controls for interest rates.

It is interesting to note that the last part of Ueda's paper (chapter 1) also contains some evidence along these lines. Ueda reports the results obtained from using vector autoregressions to decompose the variance of a measure of aggregate production. He finds that bank loans, as opposed to other measures of monetary policy such as interest rates or money supply indicators, tend to be the most significant determinant of the variance of production.

A final (potential) puzzle involving the aggregate data is that HSS find no significant correlation between their mix variable and inventory investment. Research on the United States has found that these lending effects are at least as strong for inventory investment as for fixed investment (see Kashyap, Stein and Wilcox, American Economic Review, March 1993). One way to read this finding is that the much fabled Japanese inventory management policies limit the exposure of Japanese manufacturers to sudden, unintended inventory buildups that would leave the firms dependent on bank financing. Whether or not this conjecture is correct, sorting out the differences between the U.S. and Japanese results would seem like a good topic for further study.

Using disaggregated data, HSS find that there are some predictable cross-sectional differences in the sensitivity of investment to cash flow in periods when the BoJ is clamping down on lending. In particular, for the two fiscal years between April 1978 and March 1980, firms that are not members of enterprise groups (or keiretsu) show a heightened sensitivity of investment to cash flow. The keiretsu firms show no change in this respect. HSS conclude that these increased liquidity effects are exactly what would be expected if the change in window guidance policy fell mostly on firms without tight banking relationships. Gertler and Hubbard (Symposium on Financial Market Volatility, Federal Reserve Bank of Kansas City, 1988) find similar patterns in U.S. data; namely, firms that are a priori believed to be more susceptible to liquidity constraints appear to show an increased correlation between cash flow and investment during periods following tight monetary policy.

Combining the results for the firm-level and aggregate data, one is left
with the impression that lending considerations and access to credit have historically been an important part of the monetary transmission mechanism in Japan. However, over the last few years the Japanese financial markets have been deregulated and the BoJ has formally abandoned window guidance. Thus, one open question is whether the historical importance of bank lending will be diminished in the newly deregulated environment.

The next chapter in the book examines the link between short-term and longer-term interest rates, the other major channel by which monetary policy might be thought to influence the economy. Since the BoJ can control short-term nominal interest rates, but conventional theory suggests that many spending decisions should depend on longer-term real interest rates, the study of the term structure is of central importance to any analysis of monetary policy. In their chapter, John Campbell and Yasushi Hamao provide an excellent summary of both the institutional factors that affect interest rates in Japan and the modern theory of how the term structure of interest rates is determined.

Using the theory as a guide they analyze the correlations among various short- and long-term interest rates. They report three main findings: (1) the dynamics of short-term interest rates shift somewhere around 1985, with rates exhibiting considerably less mean reversion during the late 1980s; (2) the yield curve has become a more useful forecasting tool recently compared with the early 1980s, so that when term spreads were high, rates tended to rise in the late 1980s but not in the early 1980s; (3) the expectations theory of the term structure fails to describe the data in the sense that the yield spread is systematically more variable than can be explained on the basis of forecasted values of future short-term rates. While this third finding is quite similar to the results Campbell has uncovered in his analysis of U.S. data, the first two results appear to be peculiar to Japan. As Campbell and Hamao conjecture, it is tempting to relate these shifts to the deregulation and increasing liquidity of the Japanese bond market during the late 1980s. So this chapter offers another reason for further studying of the impact of deregulation.

The last two chapters of the book directly take up the question of whether changes in monetary policy are responsible for significant variation in output. In chapter 5, Hiroshi Yoshikawa emphasizes the importance of the BoJ’s concern for interest rate smoothing. To show that interest rate smoothing was a key feature of BoJ policy, Yoshikawa documents that interest rates show little seasonality while measures of economic activity (e.g. industrial production) show significant seasonality. Because interest rate smoothing makes the money supply endogenous, most movements in monetary aggregates would be driven by movements in real variables rather than vice versa.

To study the impact of changes in policy, Yoshikawa studies bivariate
vector autoregressions between the interbank loan rate (often referred to as the 'call' rate) and various measures of expenditure. He finds that innovations in the call rate have a strong effect on investment and imports. He concludes that changes in monetary policy have been responsible for a considerable amount of the variation in economic activity in Japan.

In the last chapter of the book, Kenneth West reaches the opposite conclusion. He uses a six-variable vector autoregression, along with a set of exclusion and covariance restrictions, to identify an open economy aggregate demand–aggregate supply model. His model includes data on output, the price level, oil prices, exchange rates, U.S. output and the money supply. He finds that the money supply shocks had little impact on any variables (other than money) in the system. Instead, aggregate demand shocks and shocks to the foreign sector appear to be the most important determinant of output at horizons beyond one year.

The apparently conflicting conclusions over the significance of monetary policy can be reconciled by noting that West’s identification strategy does not include interest rate smoothing as an objective of monetary policy. To the extent that this was important, some of the monetary policy disturbances will be cataloged as ‘demand’ disturbances. Since West finds that demand disturbances were a major driving factor in the business cycle, there is no necessary contradiction between the two papers. Nevertheless, it would be interesting to see if the more structured West-style analysis would in fact uncover an important direct role for monetary policy shocks if an interest rate variable had been used to describe monetary policy.

Overall, the chapters on the transmission mechanism suggest that shifts in monetary policy in Japan have probably had a substantial real effect on the economy. How the recent deregulation of financial markets might change this will be an important topic for future research. Regardless of the ultimate consequences of deregulation, the papers in this book will continue to offer a valuable summary of how monetary policy worked during the 1960s, 1970s and 1980s.

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