

Economic Policy Challenges Lying Ahead

--- Two Years after the Crisis ---

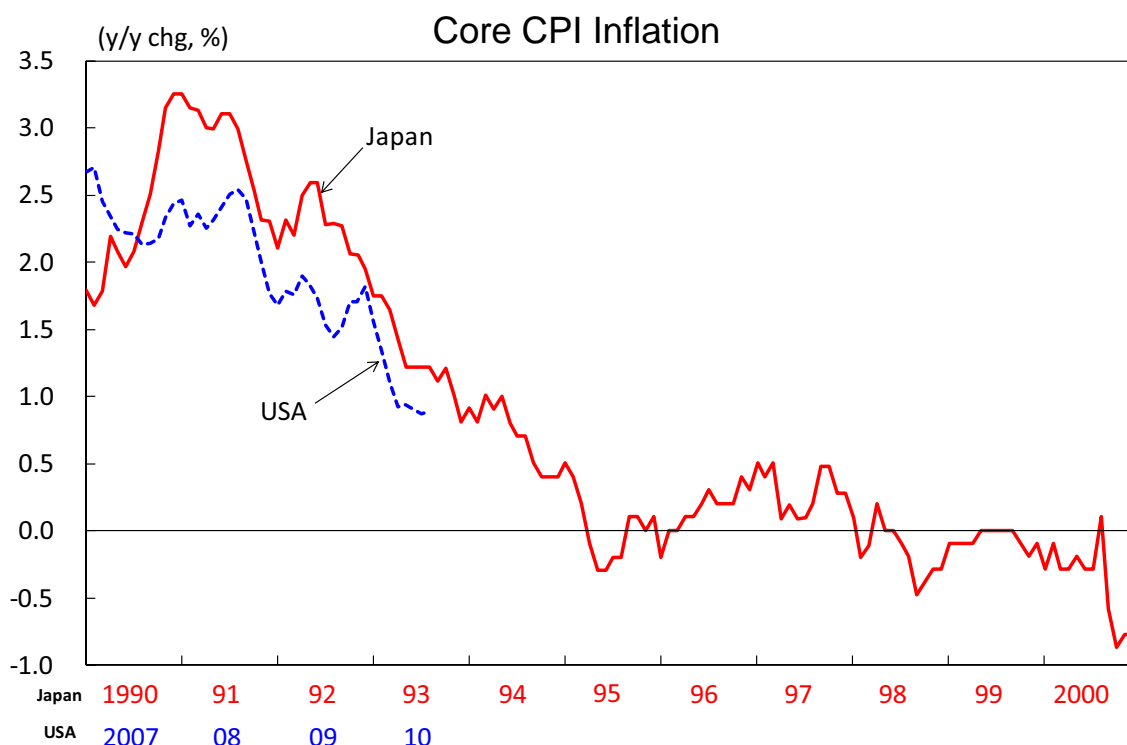
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Institute of International Finance

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Chart 1

Inflation developments in both Japan and the US after the bubble burst look similar.



Notes: Core CPI in Japan is computed by excluding perishables from headline CPI. Figures for Japan are adjusted for the changes in the consumption tax rate from 3 to 5 percent in April 1997. US data start from January 2007.

Sources: Ministry of Internal Affairs and Communications, *Consumer Price Index*; Bureau of Labor Statistics, *Consumer Price Index*.

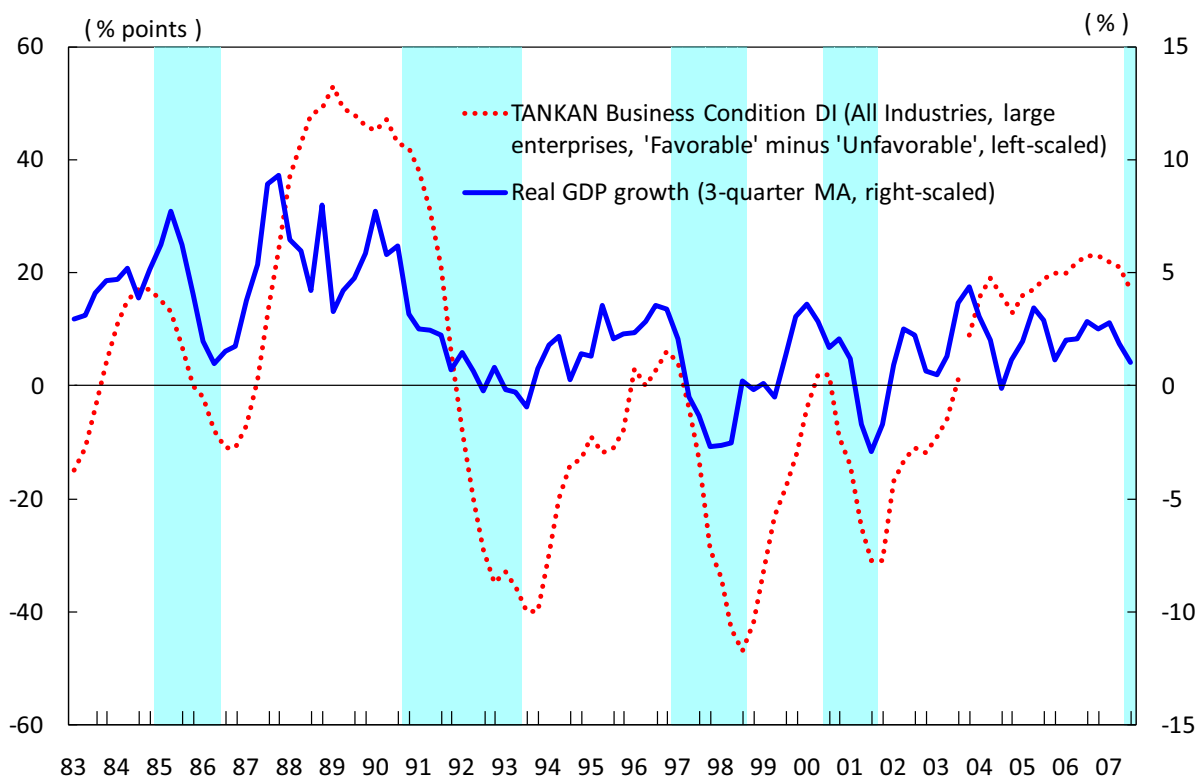
Japan's Experience

1. Took long to restore the full-fledged recovery path, creating a sense of a “false dawn.”
2. The severe contraction triggered by destabilizing interbank funding markets, while limited compared with the recent global crisis.
3. Experienced mild deflation, but not a deflationary spiral.
4. Labor practice affected inflation developments.
5. Demographic changes significantly affected economic performance.

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Chart 2: Japan's Experience 1

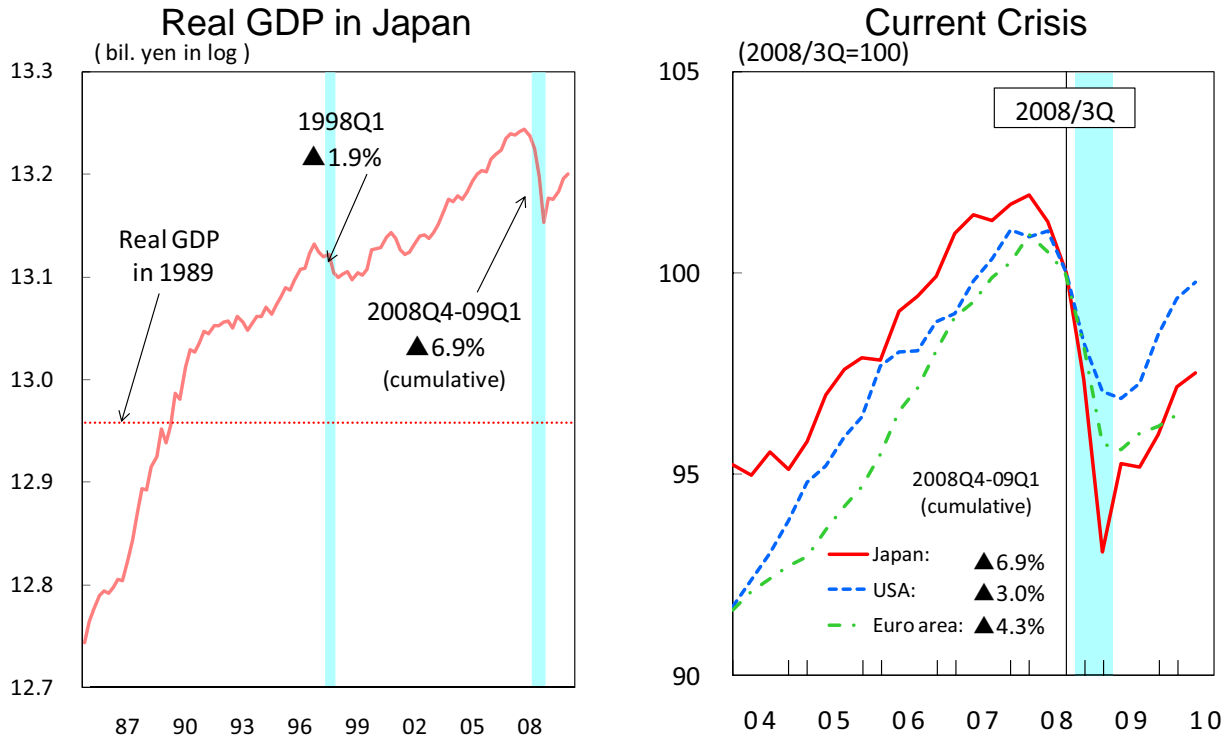
Took long to restore the full-fledged recovery path, creating a sense of a “false dawn.”



Note: Shaded areas indicate business cycle contraction periods.

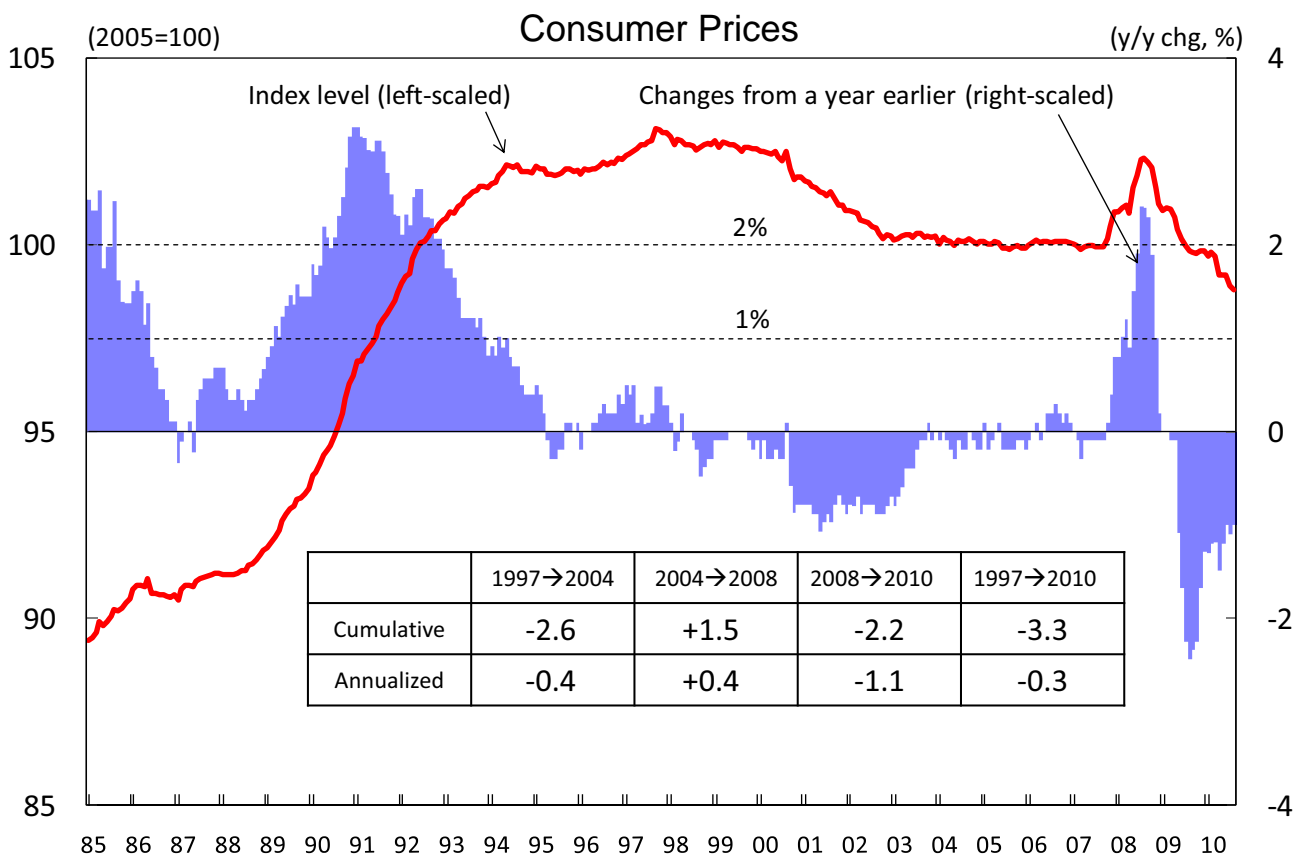
Sources: Cabinet Office, *Annual Report on National Accounts*; Bank of Japan, *TANKAN (Short-Term Economic Survey of Enterprises in Japan)*. 3

The severe contraction triggered by destabilizing interbank funding markets, while limited compared with the recent global crisis.



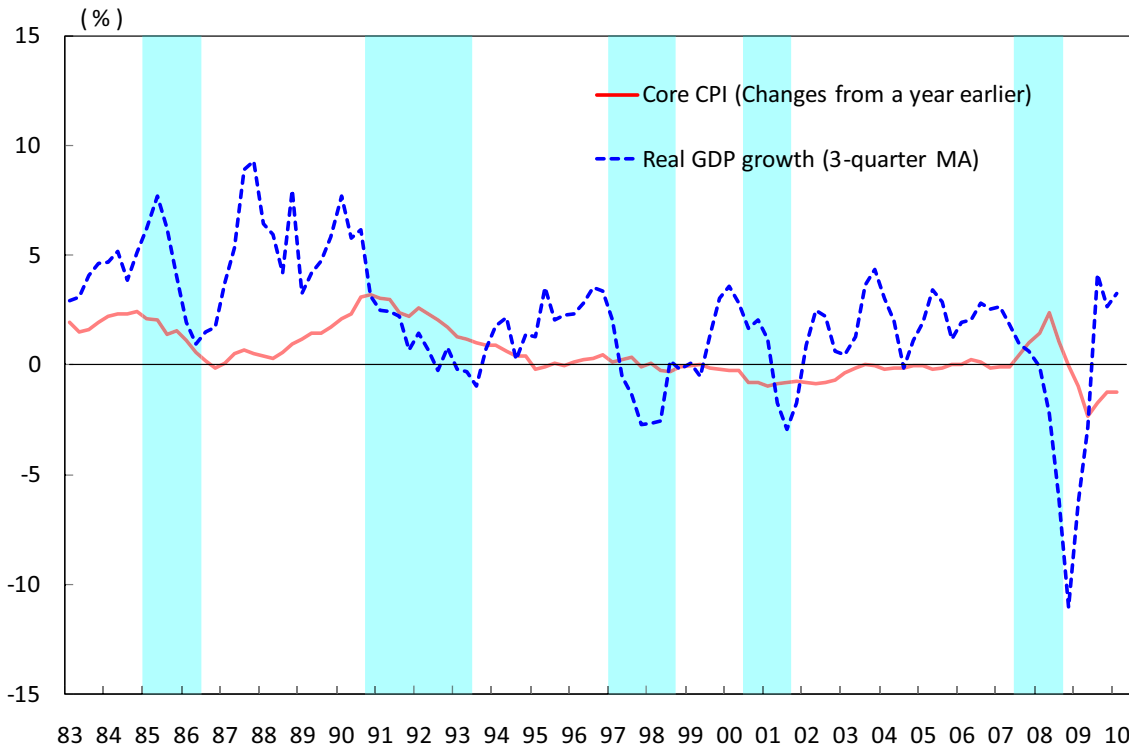
Sources: Cabinet Office, *Annual Report on National Accounts*; US Bureau of Economic Analysis, *National Economic Accounts*; Eurostat, *National Accounts*.

Japan experienced mild deflation from 1998.



Note: Figures are adjusted for the impact of consumption tax, which introduced at 3 percent in 1989, and raised to 5 percent in 1997.
Source: Ministry of Internal Affairs and Communications, *Consumer Price Index*.

In spite of mild deflation, Japan registered the longest recovery from 2002 to 2007.



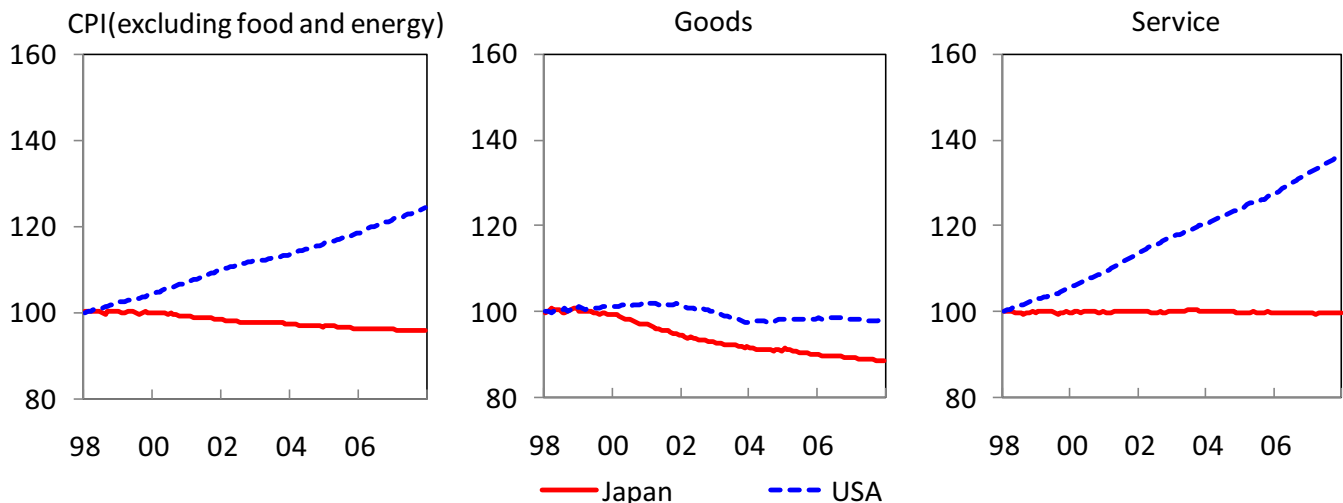
Note: Figures for CPI are adjusted for the impact of consumption tax, which introduced at 3 percent in 1989, and raised to 5 percent in 1997. Shaded areas indicate business cycle contraction periods.

Sources: Cabinet Office, *Annual Report on National Accounts*; Ministry of Internal Affairs and Communications, *Consumer Price Index*. 6

Labor practice affected inflation developments.

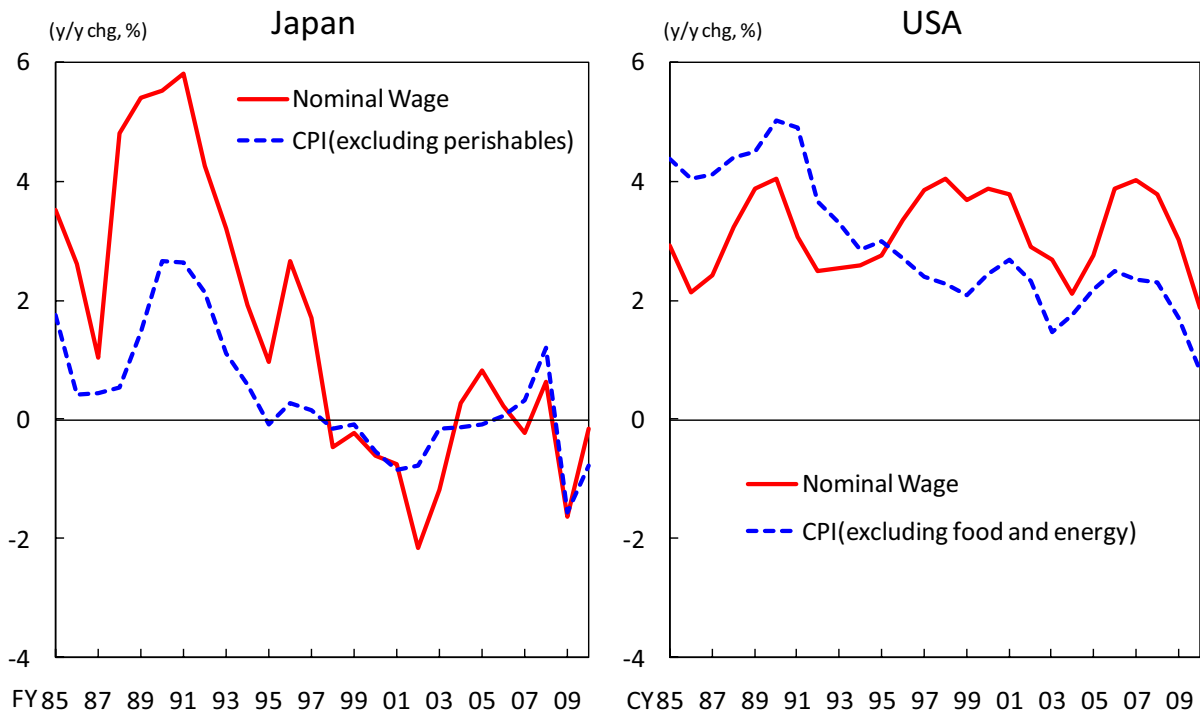
Cumulative changes from 1998 to 2007			
	Japan(a)	USA(b)	(a)-(b)
CPI	-4.2	+21.5	-25.7
Goods	-4.1	-0.7	-3.4
Services	-0.1	+22.2	-22.3

CPI inflation differential between Japan and USA is explained mostly by a decline in service prices in Japan.



Sources: Ministry of Internal Affairs and Communications, *Consumer Price Index*; Bureau of Labor Statistics, *Consumer Price Index*.

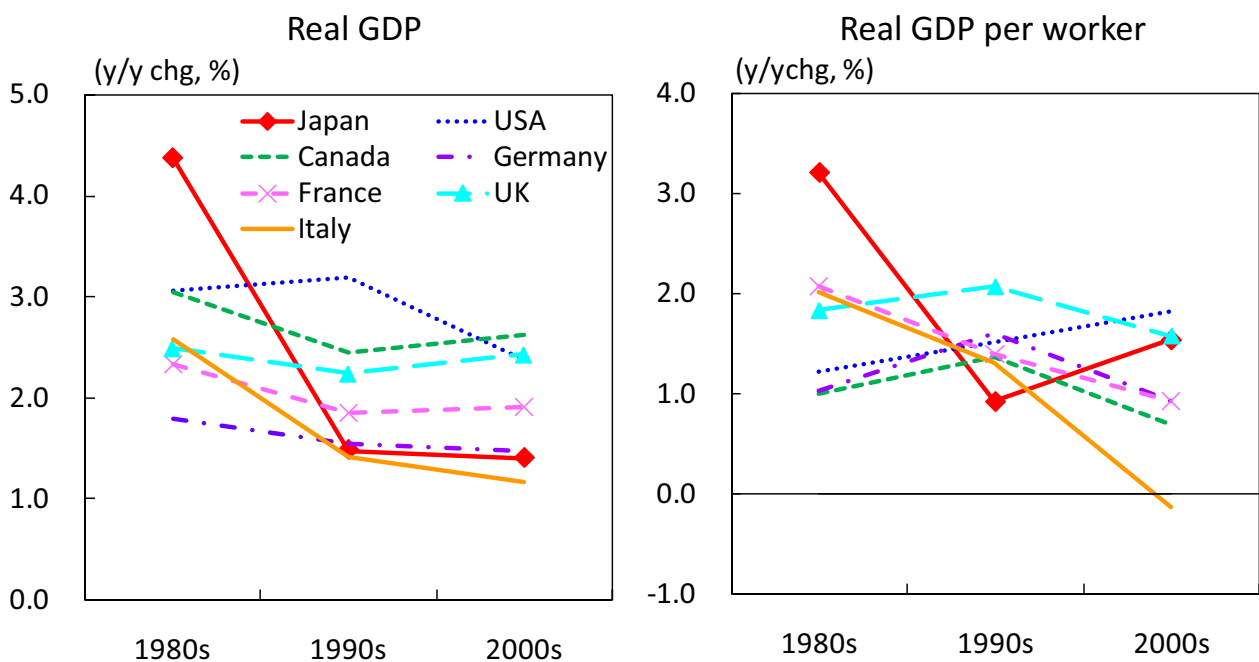
Downward rigidity in nominal wages disappeared in the late 1990s in Japan.



Notes: Figures of nominal wages are on a per hour basis. Figures for CPI in Japan are adjusted for the impact of consumption tax, introduced at 3 percent in 1989, and raised to 5 percent in 1997.

Sources: Ministry of Internal Affairs and Communications, *Consumer Price Index*; Ministry of Health, Labour and Welfare, *Monthly Labour Survey*; US Bureau of Labor Statistics, *Consumer Price Index*, and *Average Hourly Earnings*.

Demographic changes significantly affected economic performance.



Notes: 1. The figures for Germany for the 1980s are West Germany. The figures for Germany for the 1990s are the average from 1992 to 1999.

2. The figures for the period since 2000 are from 2000 through 2008.

Sources: Organisation for Economic Co-operation and Development, *OECD.Stat* and other governmental sources.

Economic Policy after the Burst of Bubble: Major and Common Challenges for Advanced Economies

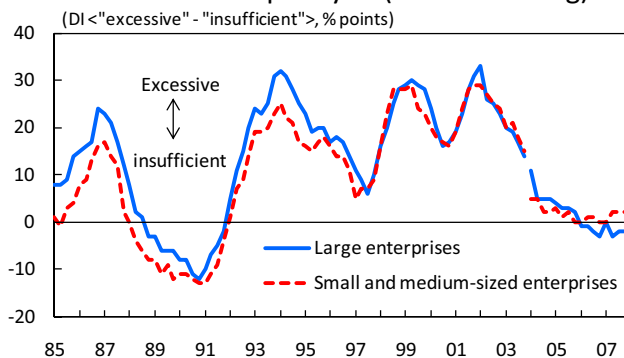
1. Importance of financial system stability.
2. Monetary easing as a necessary action.
3. Need for clear recognition of long adjustment process before full-fledged recovery.
4. Importance of flexibility in economic structure.
5. Unintended consequences of prolonged unprecedented easy monetary policy.
6. Financial reform in a balanced manner.

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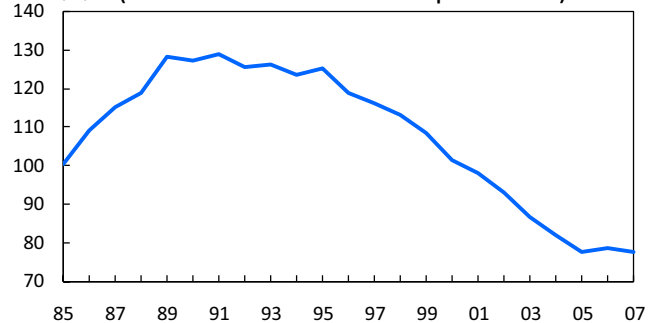
Chart 9

Resolution of Japan's "three excesses" came before the full-fledged recovery.

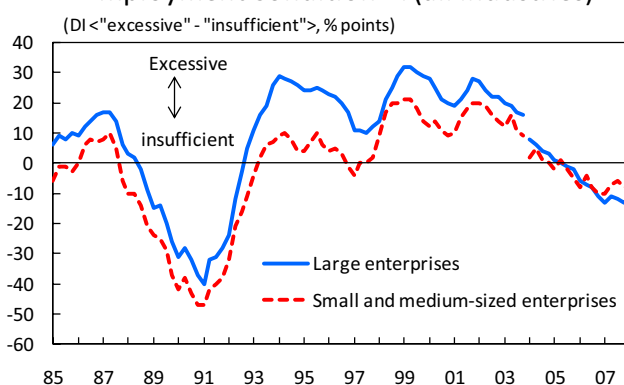
Production Capacity DI (manufacturing)



Ratio of debts to nominal GDP
(Private non-financial corporations)



Employment Condition DI (all industries)

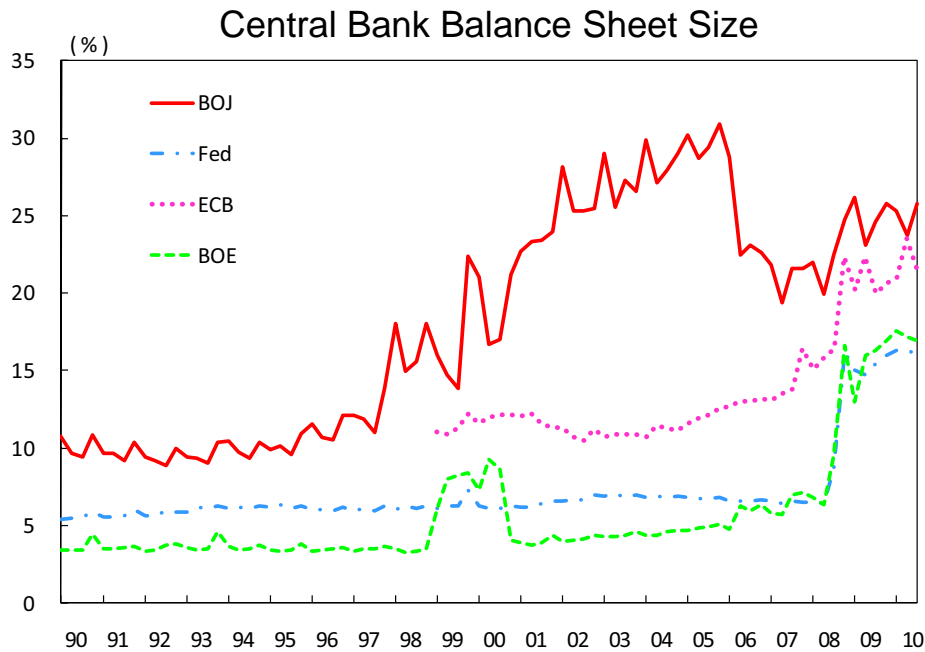


Notes: 1. The Tankan has been revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on a new basis.

2. Debts is the sum of loans and securities (other than equities) in private non-financial corporations.
 Sources: Cabinet Office, *Annual Report on National Accounts*; Bank of Japan, *Bank of Japan, Tankan, Short-Term Economic Survey of Enterprises in Japan, Flow of Funds*.

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The ratio of the BOJ's B/S size to GDP increased by more than 20 percentage points at its peak, which were twice as large as that in the Fed, the ECB, and the BOE in the recent crisis.



Notes: 1. The latest figures are the ratio of balance sheet size at the end of August, 2010 to nominal GDP for the second quarter of 2010.

2. The BOE's balance sheet increased temporarily from 1999 to 2000 reflecting a technical factor associated with the BOE's participation to the TARGET system, the settlement and clearing system for euro.

Sources: Bank of Japan, Board of Governors of the Federal Reserve System, European Central Bank, Bank of England.