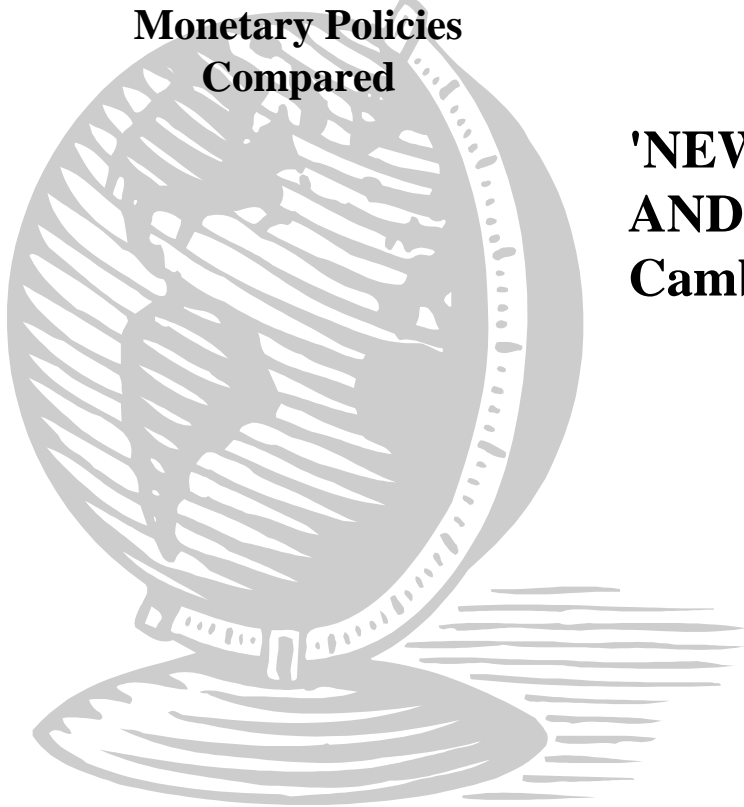


Valance Co., Inc.

March 18-20, 2004

**Fed and Japanese
Monetary Policies
Compared**



**'NEW' MONETARY POLICY: IMPLICATIONS
AND RELEVANCE
Cambridge University**

**Karim Basta
Valance Co., Inc.**

The Lesson

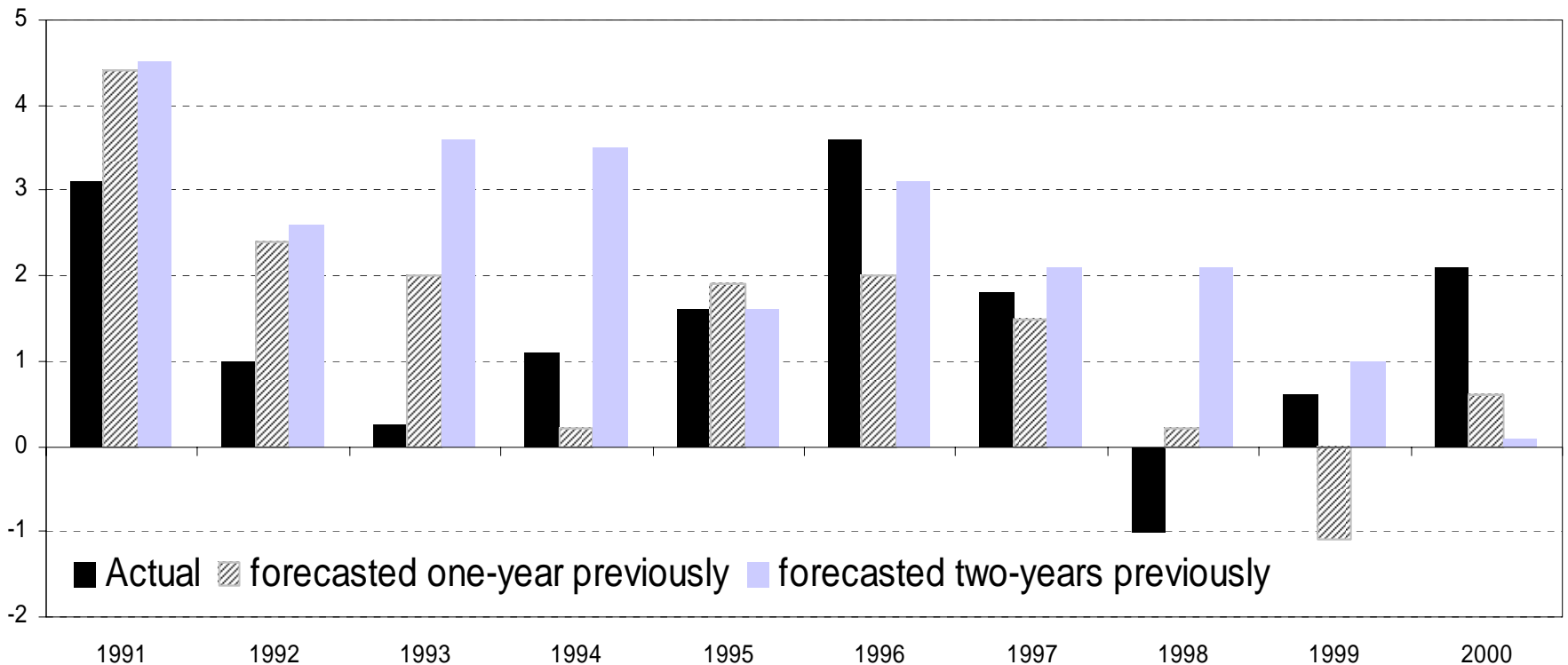
We draw the general lesson from Japan's experience that when inflation and interest rates have fallen close to zero, and the risk of deflation is high, stimulus-both monetary and fiscal-should go beyond the levels conventionally implied by baseline forecasts of future inflation and economic activity.

Recognizing When It's Different

... analogously to monetary policy, Japanese fiscal policy became relatively stimulative in the early 1990s by conventional standards, but should have become even more aggressive in an effort to prevent a deflationary slump. The increase in the structural deficit in Japan during the first half of the 1990s generally exceeded that which occurred in several other industrial countries experiencing economic downturns, confirming that fiscal policy was far from unresponsive to the weakening economy. With the benefit of hindsight, however, it is obvious that in none of the other economies was the risk of deflation so pronounced, and hence the need for further fiscal stimulus so great.

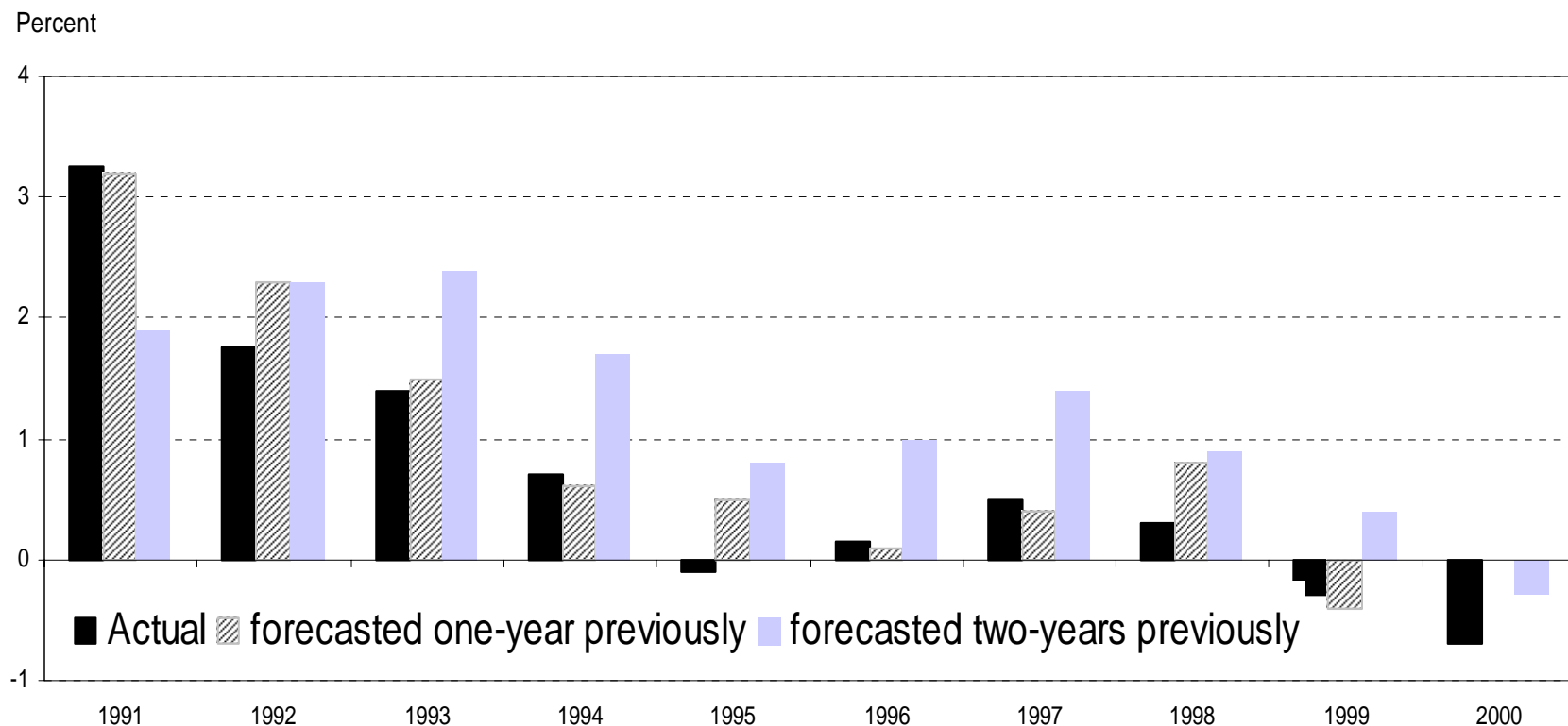
Consensus Growth Forecast Japan 1991-2000

Percent



*GDP growth on a year-average-over-year-average basis (Q4/Q4 not available)

Consensus Inflation Forecasts Japan 1991-2000



*Change in CPI on a year-average-over-year-average basis (Q4/Q4 not available), adjusted from April 1997 through March 1998 for consumption tax increase.

Fiscal Policy Indicators: Japan Fiscal Status

(Percent)

	GDP Growth (Q4/Q4)	Output Gap (Q4 Estimate)	Actual Deficit/ GDP (OECD)	Gross Debt/ GDP (OECD)	Net Debt GDP (OECD)	Changes in Structural Deficit
1990	4.7	3.3	1.9	64.6	12.4	0.5
1991	2.5	2.5	1.8	61.6	6.4	0.1
1992	0.1	-0.1	0.8	63.5	7.3	0.2
1993	0.3	-2.0	-2.4	69.0	10.1	2.4
1994	1.6	-2.4	-2.8	73.9	12.1	0.1
1995	2.5	-1.7	-4.2	80.4	16.9	1.2

G-7 Fiscal Situation in Recessionary Periods (Percent)

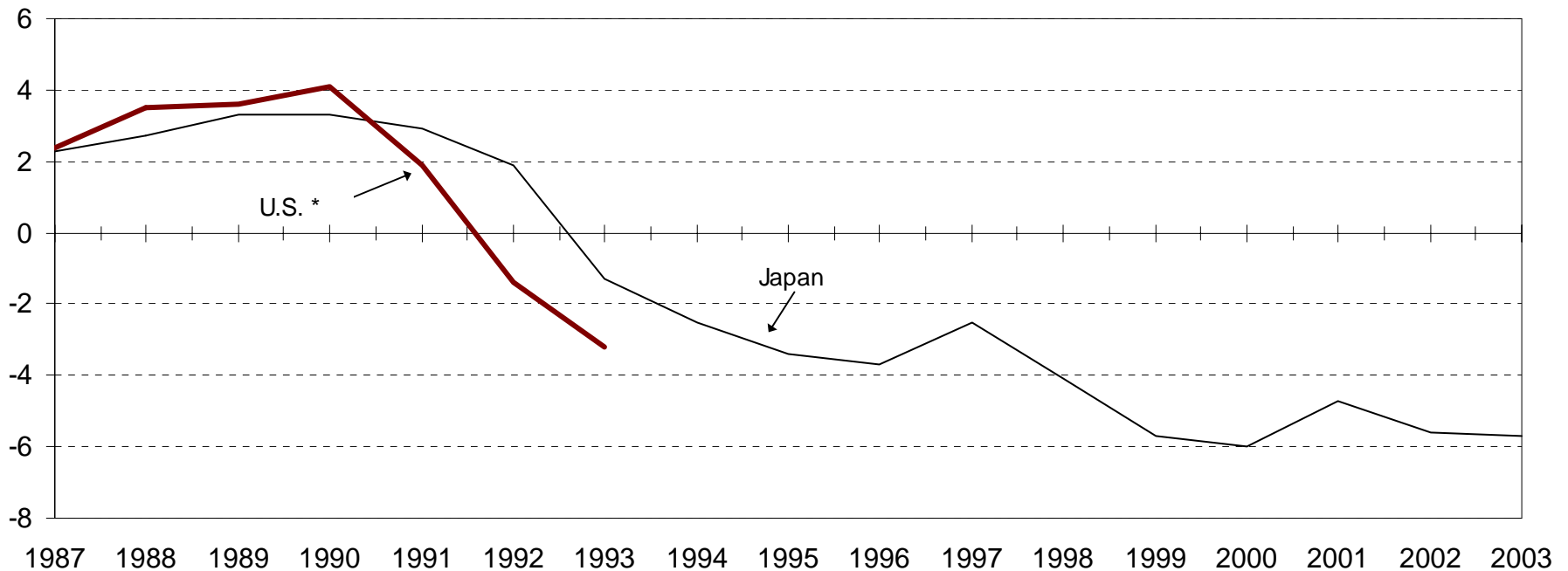
GDP Growth (Q4/Q4)		Output Gap (Q4 Estimate)		Changes in Structural Deficit			
United States				United States			
1981	1.2	-5.4	-0.5	1990	0.5	-2.4	0.8
1982	-1.6	-9.6	1.1	1991	0.8	-3.7	-0.2
1983	7.6	-5.5	1.2	1992	4	-2.1	1.1
1984	5.6	-3.1	0.4	1993	2.6	-1.9	-0.8
West Germany				Germany			
1981	0.6	-0.7	-0.3	1992	0.7	0	-0.3
1982	-1.3	-3.9	-2	1993	-0.3	-1.6	-0.7
1983	3.9	-1.9	-0.8	1994	2.9	0.1	-0.1
1984	2.6	-1	0	1995	1.1	-0.2	1.1
Canada				Canada			
1981	1.7	-1.5	-1.1	1990	-1.2	-0.7	0.2
1982	-3.7	-7.6	1.1	1991	-0.6	-3.8	0.1
1983	6.2	-4.4	1.3	1992	0.9	-5.3	-0.1
1984	5.7	-1.6	1.3	1993	2.9	-4.9	-0.5
United Kingdom				United Kingdom			
1979	2	3.5	-0.5	1990	-0.5	0.6	1.6
1980	-4.1	-2.2	-2.3	1991	-0.6	-1.7	-1.1
1981	0.7	-3.2	-1.5	1992	0.9	-2.7	2.7
1982	2	-3.2	-1	1993	3.4	-1.5	1.7
1983	4.5	-1.6	1.2	1994	4.9	0.9	0.4
France				Italy			
1992	0.1	0	1.4	1990	0.7	0	1.2
1993	0.3	-2.1	0.2	1991	1.9	1.1	-1.3
1994	2.9	-1.1	-0.5	1992	-0.8	-1.1	-1
1995	0.6	-2.4	0	1993	0.1	-2.4	-1.8

Wrong Fiscal Mix?

The actual choices made by the fiscal authorities can best be understood in the light of several factors. First, owing in part to more limited social safety nets, Japan's budget is less cyclically sensitive than in other industrial countries and provides fewer automatic stabilizers. Therefore, fiscal stimulus is much more reliant on discretionary fiscal action in Japan. Second, partially due to concerns about the effect of an aging population on future budgets, the authorities initially were extremely reluctant to undertake any measures that could have become embedded on a sustained basis in future budgets.

Similarities & Differences: Japan 1987-2003 vs. U.S. 1997-2003

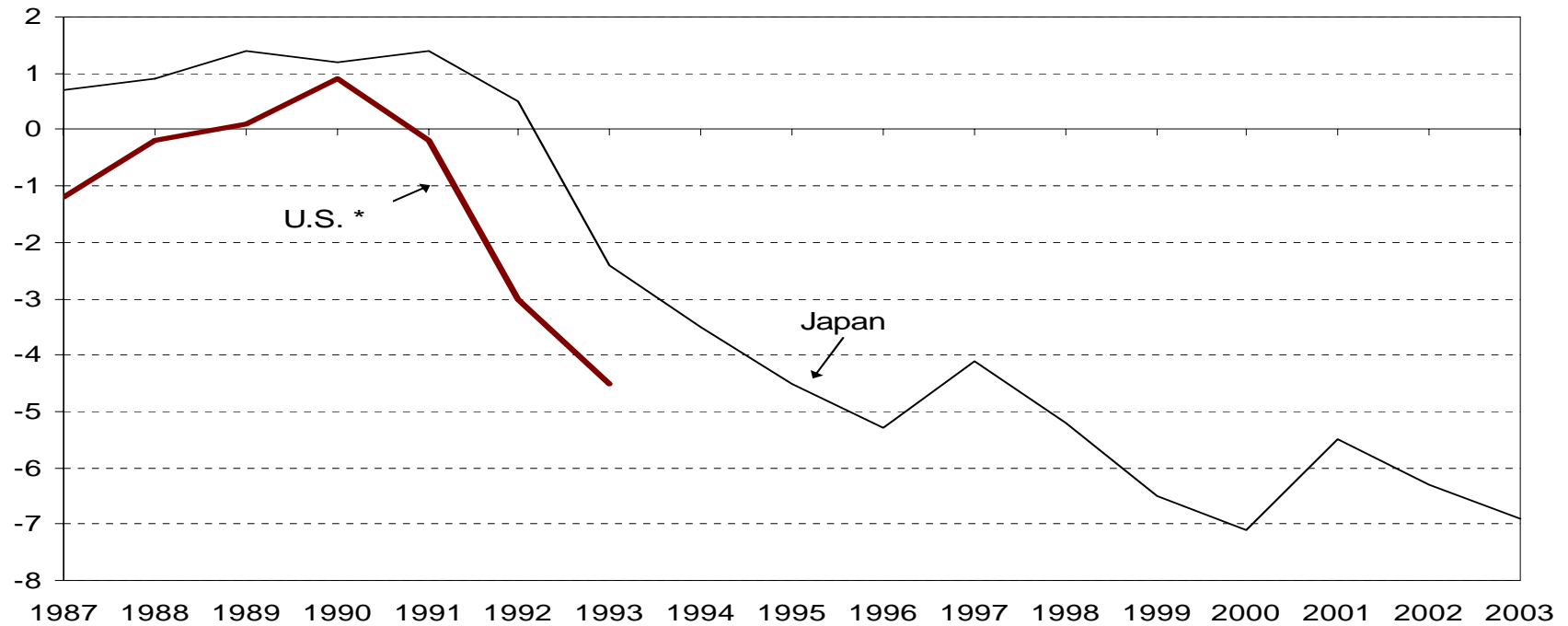
General Government Primary Balances



* U.S.: 1997-2003
Data Source: OECD

Similarities & Differences: Japan 1987-2003 vs. U.S. 1997-2003

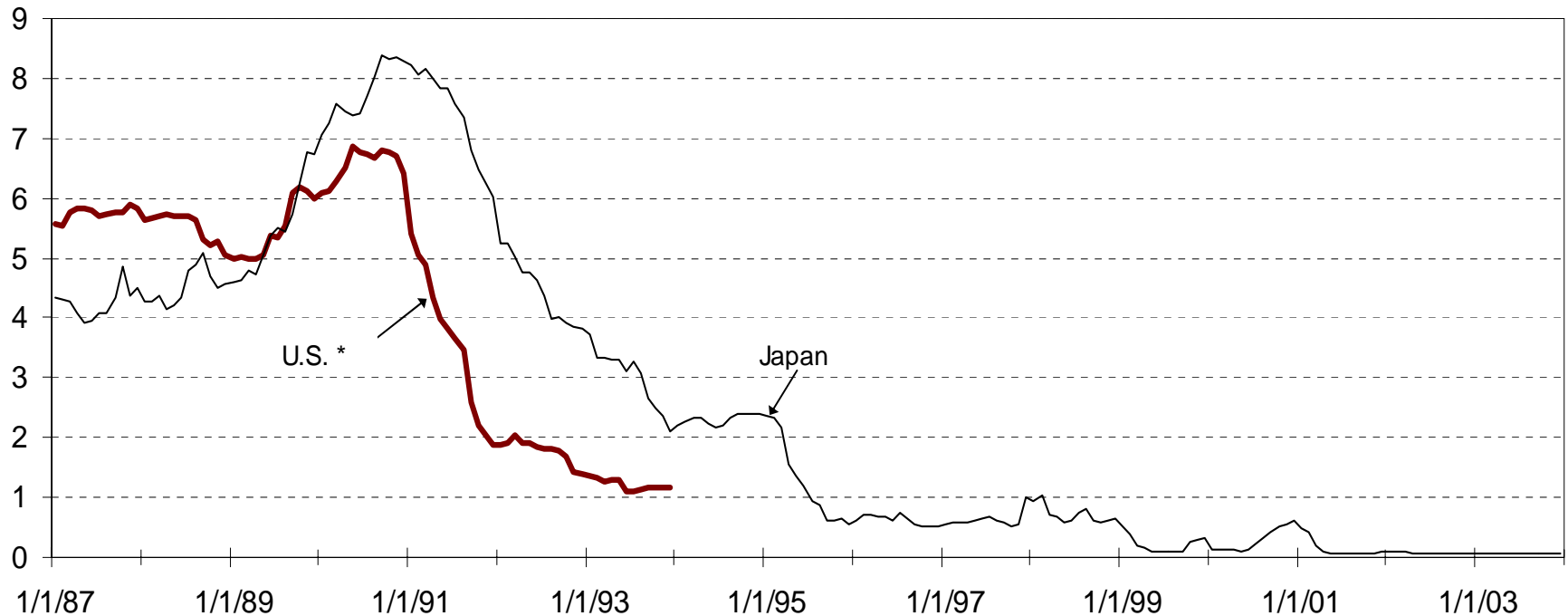
Cyclically-adjusted General Government Balances



* U.S.: 1997-2003
Data Source: OECD

Similarities & Differences: Japan 1987-2004 vs. U.S. 1997-2004

Short-Term Interest Rates



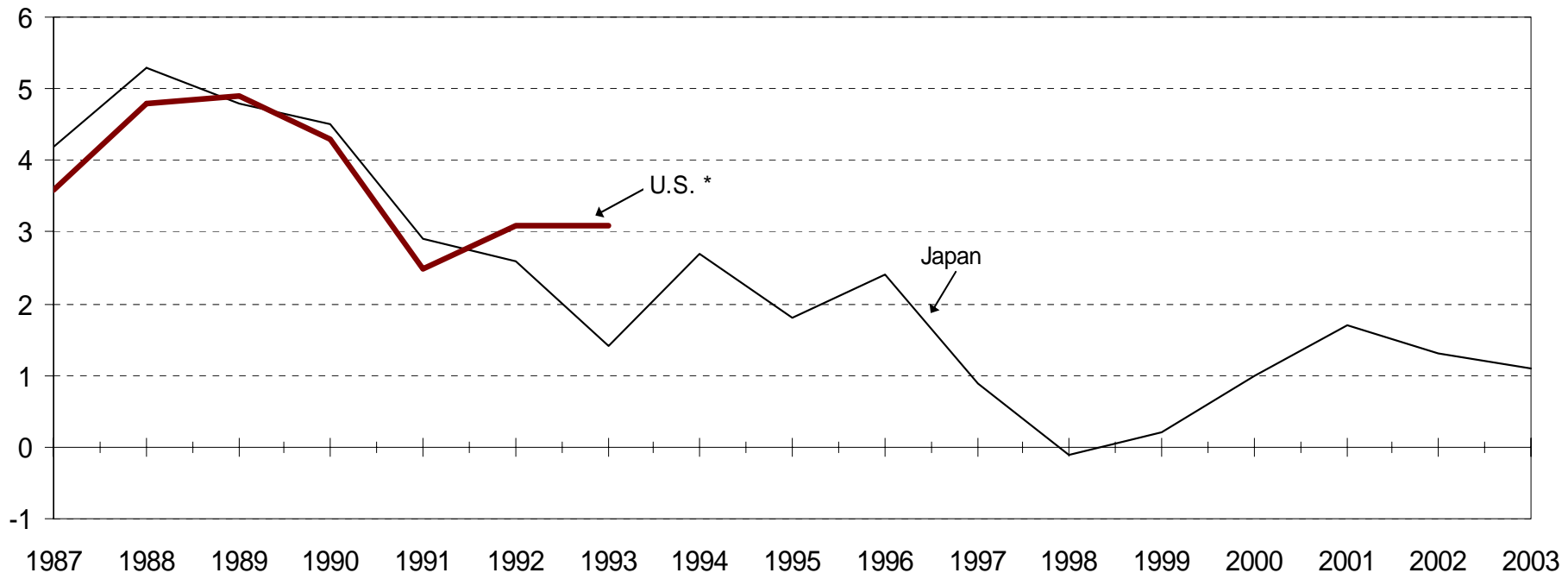
* U.S.: 1/97-2004

3 MONTH LIBOR

Data Source: Datastream

Similarities & Differences: Japan 1987-2003 vs. U.S. 1997-2003

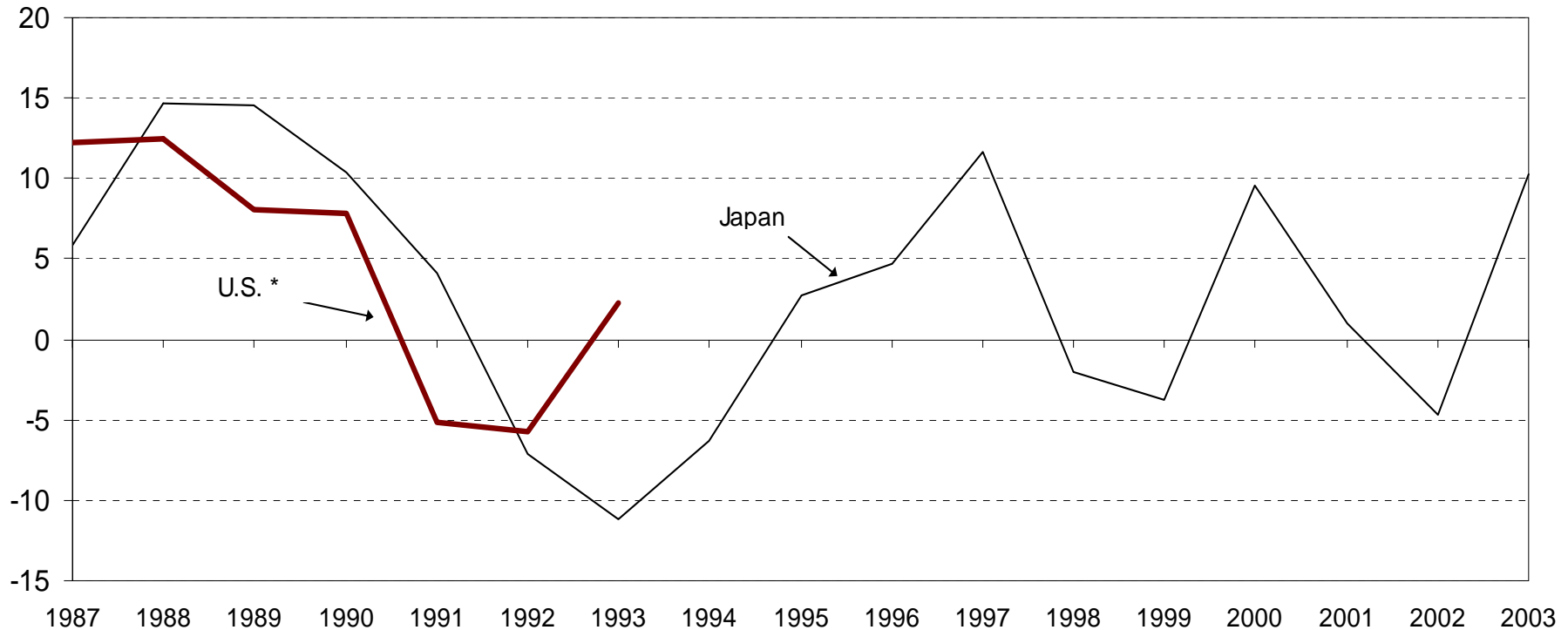
Real Private Consumption Expenditure



* U.S.: 1997-2003
Data Source: OECD

Similarities & Differences: Japan 1987-2003 vs. U.S. 1997-2003

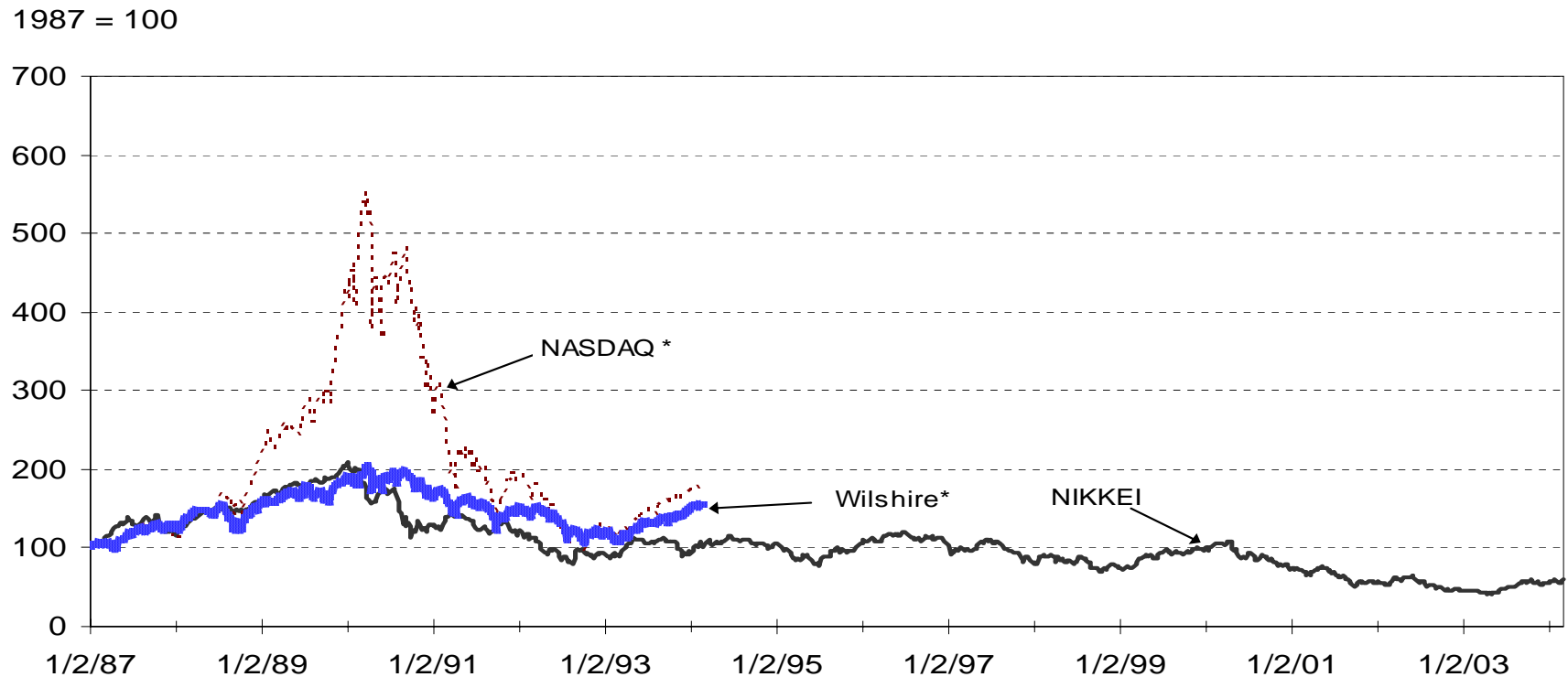
Real Gross Private Non-Residential Fixed Capital Formation



* U.S.: 1997-2003
Data Source: OECD

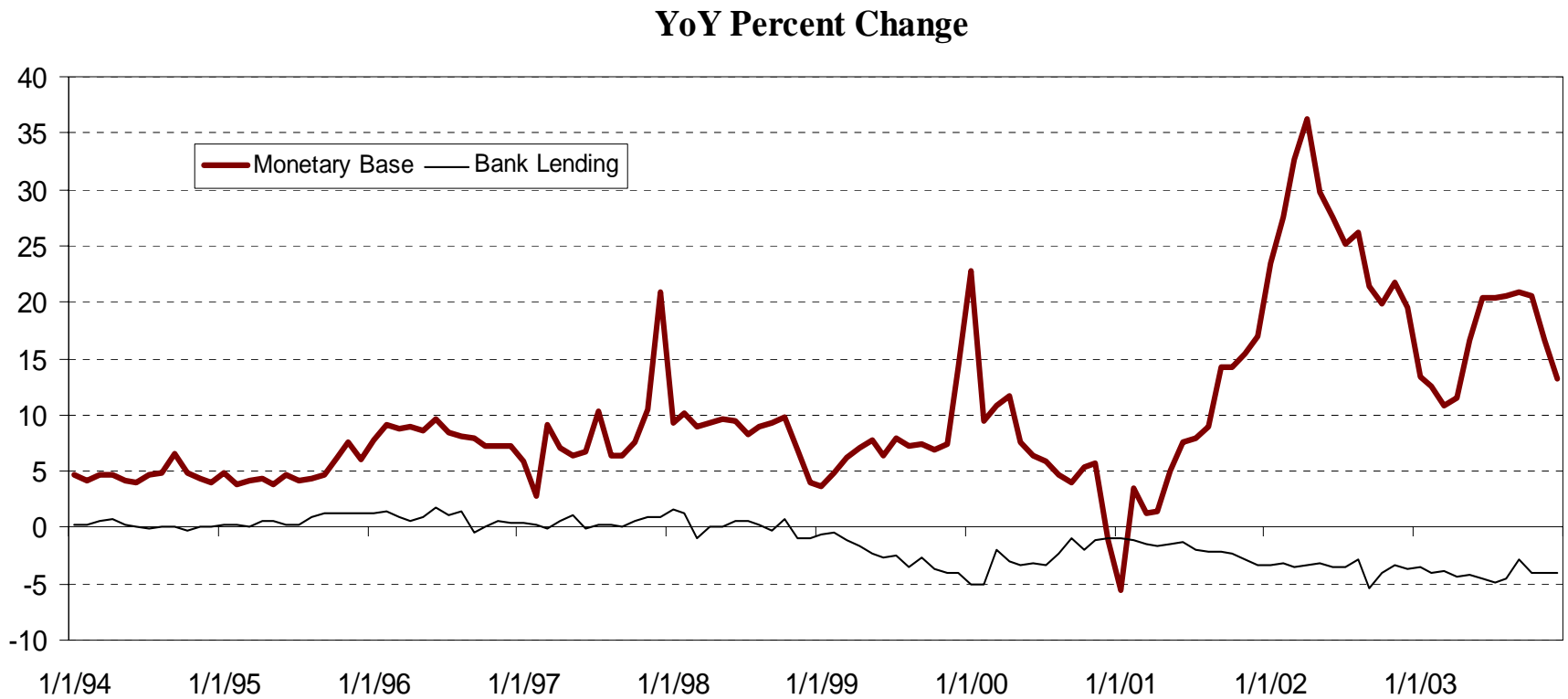
Similarities & Differences: Japan 1987-2004 vs. U.S. 1997-2004

NIKKEI vs NASDAQ & Wilshire



* NASDAQ and Wilshire Indices 1/97-2004
Data Source: Datastream

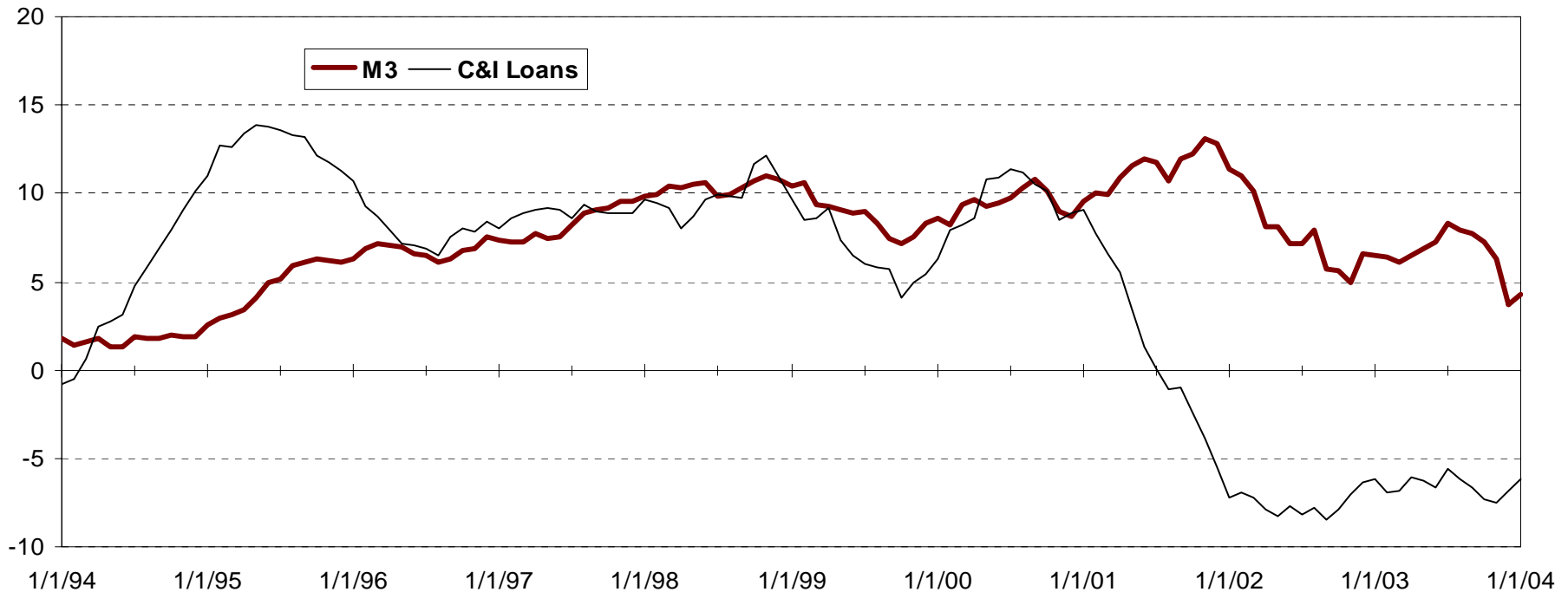
Japan Bank Lending vs. Monetary Base



Data Source: Bank of Japan

U.S. Bank Lending vs. M3

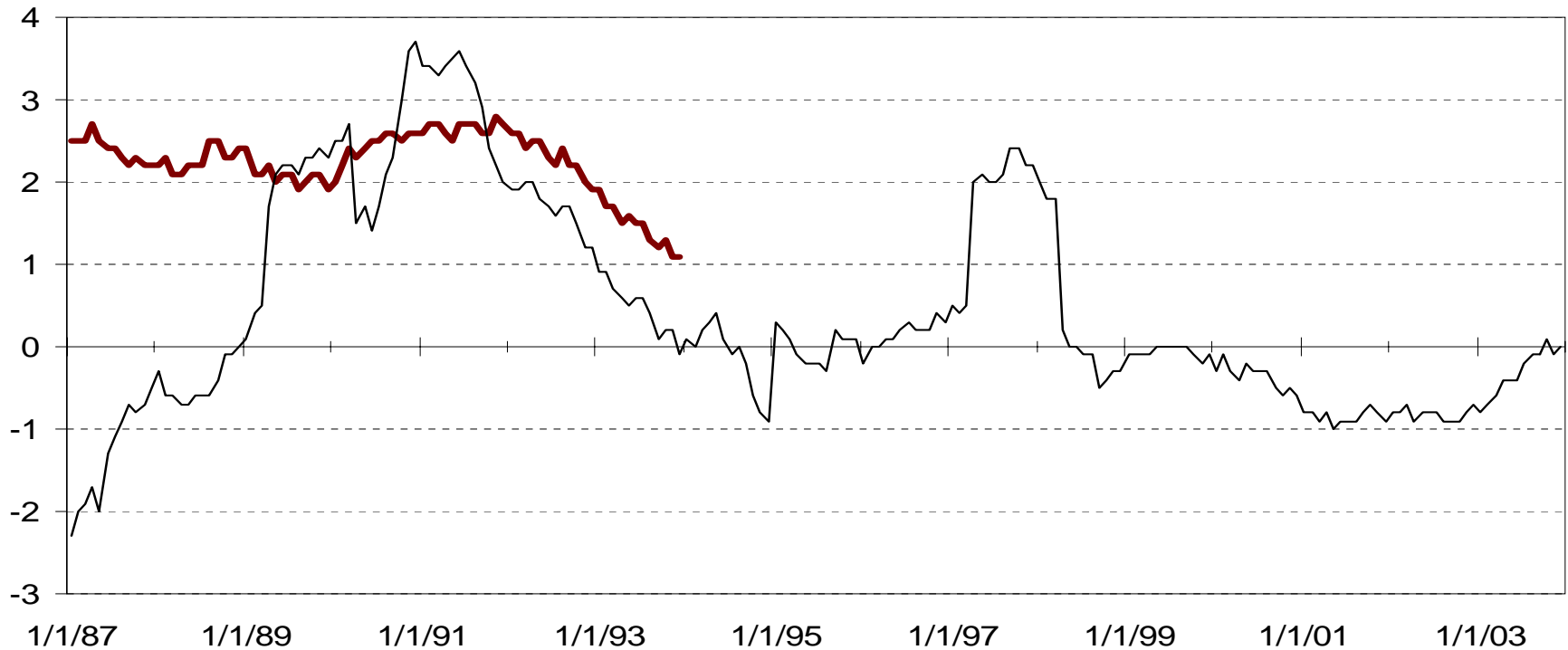
YoY Percent Change



Data Source: Federal Reserve

Similarities & Differences: Japan 1987-2004 vs. U.S. 1997-2004

Core CPI

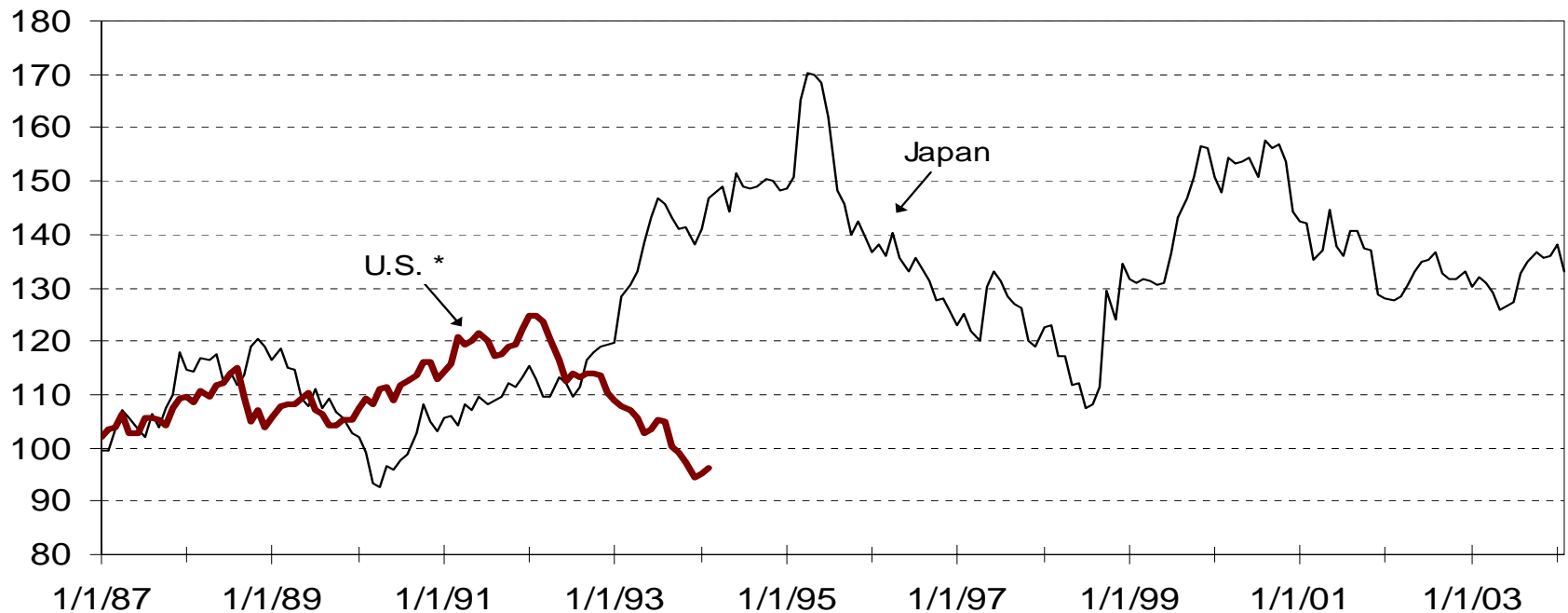


* U.S.: 1/97-2004

Data Sources: Bureau of Labor Statistics &
Ministry of Public Management, Home Affairs, Posts and Telecom.

Similarities & Differences: Japan 1987-2004 vs. U.S. 1997-2004

Trade Weighted Yen vs Dollar

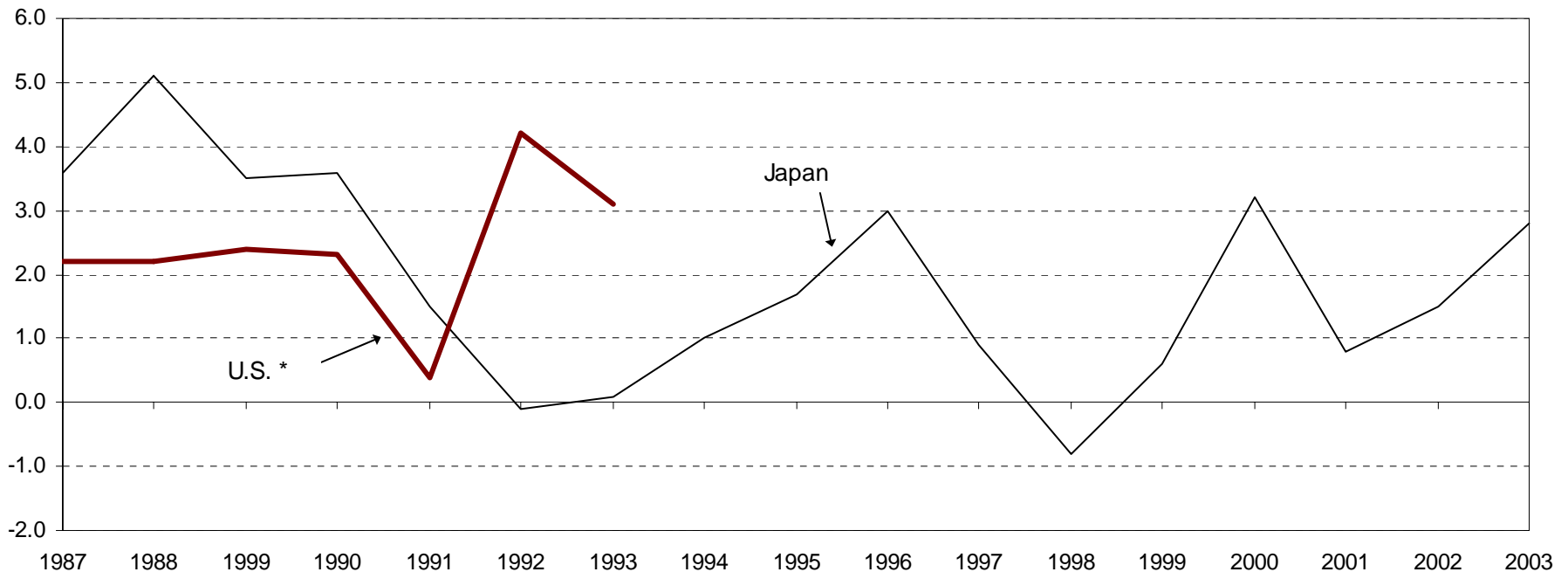


* U.S.: 1/97-2004

Data Source: Bank of England

Similarities & Differences: Japan 1987-2003 vs. U.S. 1997-2003

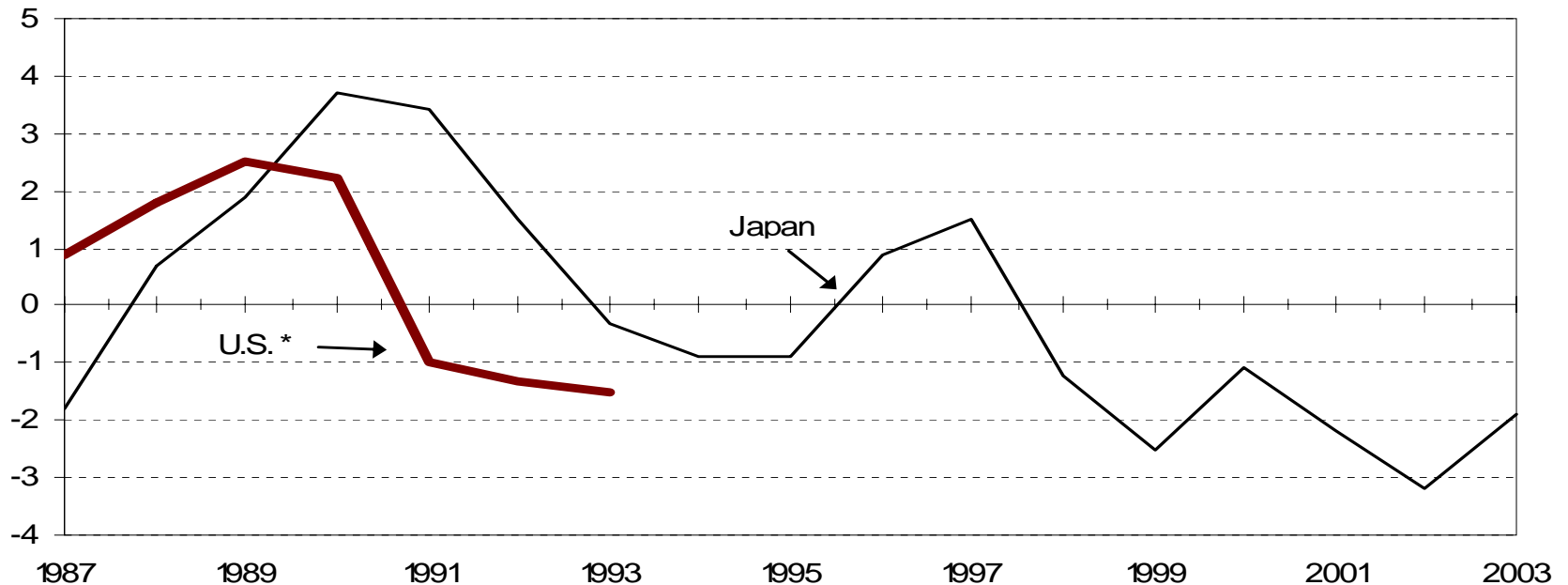
Labor Productivity in the Business Sector
YoY Percent Change



* U.S.: 1997-2003
Data Source: OECD

Similarities & Differences: Japan 1987-2003 vs. U.S. 1997-2003

Output Gap



* U.S.: 1997-2003
Data Source: OECD

Greenspan Speech On February 27, 2004

“Intellectual Property Rights”

Importance Of Productivity

“Over the past half-century, the increase in the value of raw materials has accounted for only a fraction of the overall growth of U.S. gross domestic product (GDP). The rest of that growth reflects the embodiment of ideas in products and services that consumers value. This shift of emphasis from physical materials to ideas as the core of value creation appears to have accelerated in recent decades.

Technological advance is continually altering the shape and nature of our economic processes and, in particular, is promoting the trend toward increasing conceptualization of U.S. GDP. The size of our radios, for example, has been dramatically reduced by the substitution of transistors for vacuum tubes. Thin fiber optic cable has replaced huge tonnages of copper wire. New architectural, engineering, and materials technologies have enabled the construction of buildings enclosing the same space with far less physical material than was required, say, 50 or 100 years ago. More recently, mobile phones have markedly downsized as they have improved. The movement over the decades toward production of services requiring little physical input has also been a major contributor to the marked rise in the ratio of constant dollars of GDP to ton of input.”

Bernanke's Speech On July 23, 2004

"An Unwelcome Fall in Inflation"

A long-overdue window of transparency on the Fed's inflation model which in turn shed light on their likely "reaction function" as far as the start of the next tightening cycle.

Model has 4 inputs:

- *Excess capacity*
- *Inflation expectations*
- *Supply side shocks (e.g. oil, food)*
- *Inflation persistence (inertia)*

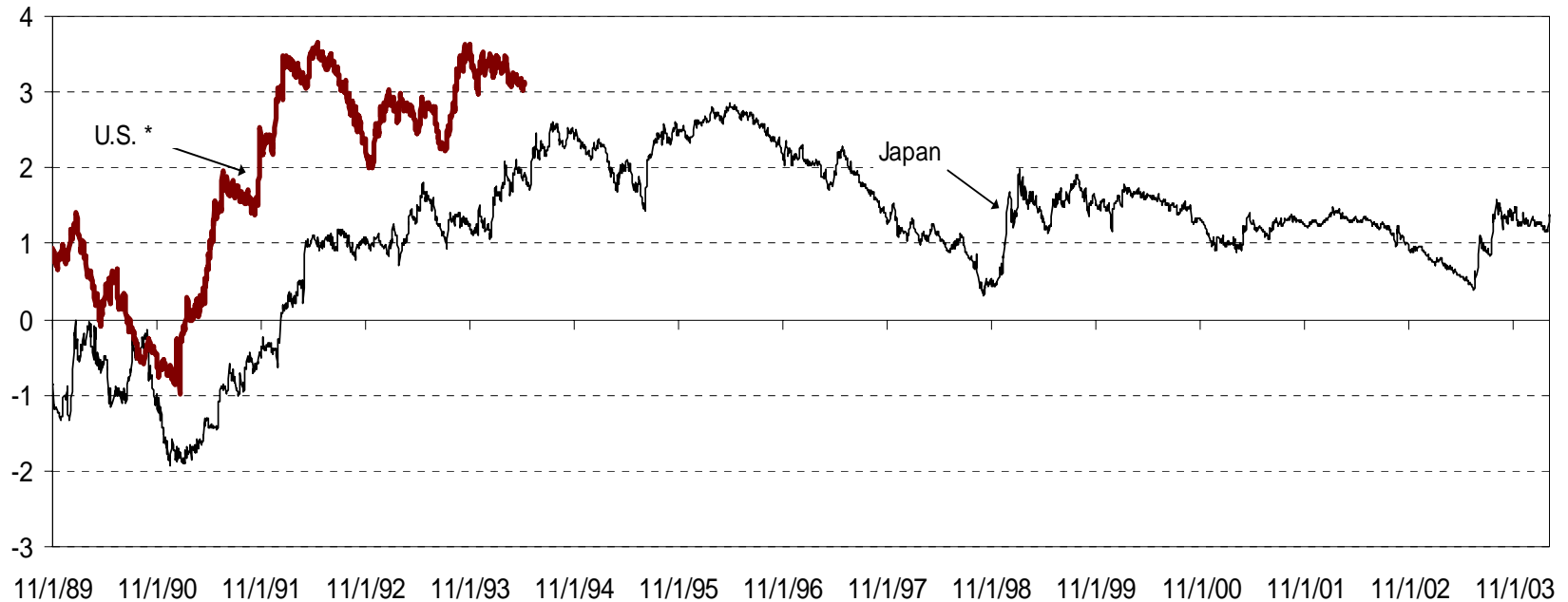
Of the four, capacity dominates the most near-term. On the assumption that the economy grows at potential (4%) in 2004, the Fed's model suggested the core PCE deflator would fall from the then current 1.2% to 0.7% by the end of 2004 (basically, at current levels of spare capacity, trend growth implied an annual fall in inflation of 0.4%). He stated that the error parameters in the Fed's model could imply an inflation rate below 0% by the end of 2004 and inferred that the lack of sufficient above-trend growth in 2005 or 2006 could lead to inflation below 0% in those years.

Premature Tightening?

Given the advantages of loosening both monetary and fiscal policy, particularly in 1994, why did the Japanese not pursue such a policy? The answer probably has both an economic and a political component. First, as noted earlier, the economy had begun to recover that year, and the authorities may have viewed the increase in both interest rates and the exchange rate as validation by the market that the slump was nearing an end, rather than as an impediment to growth that needed to be counteracted.

Similarities & Differences: Japan 1987-2003 vs. U.S. 1997-2003

Yield Curve 10yr - 3mth

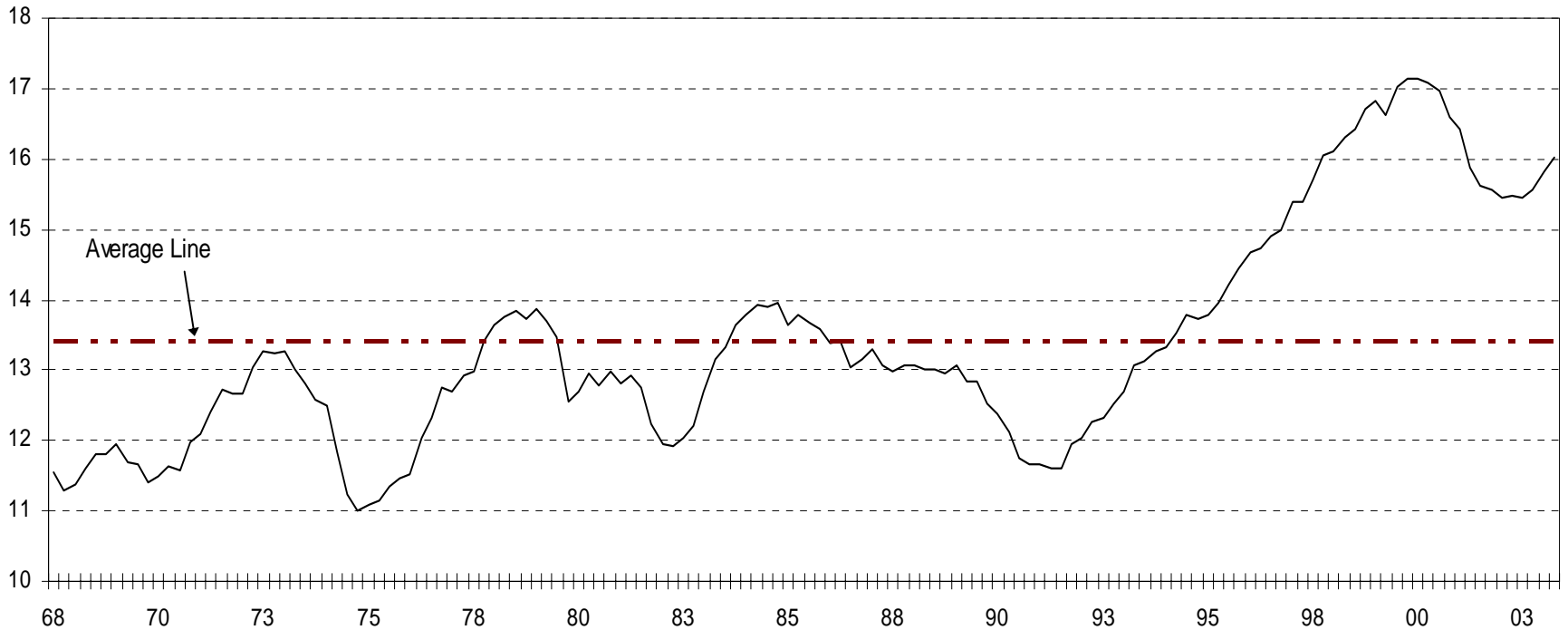


*U.S.: 1997-2003

Data Source: Bloomberg

U.S. Fixed Investment as Share of GDP

Volume, in Percent



Data Source: Bureau of Economic Analysis

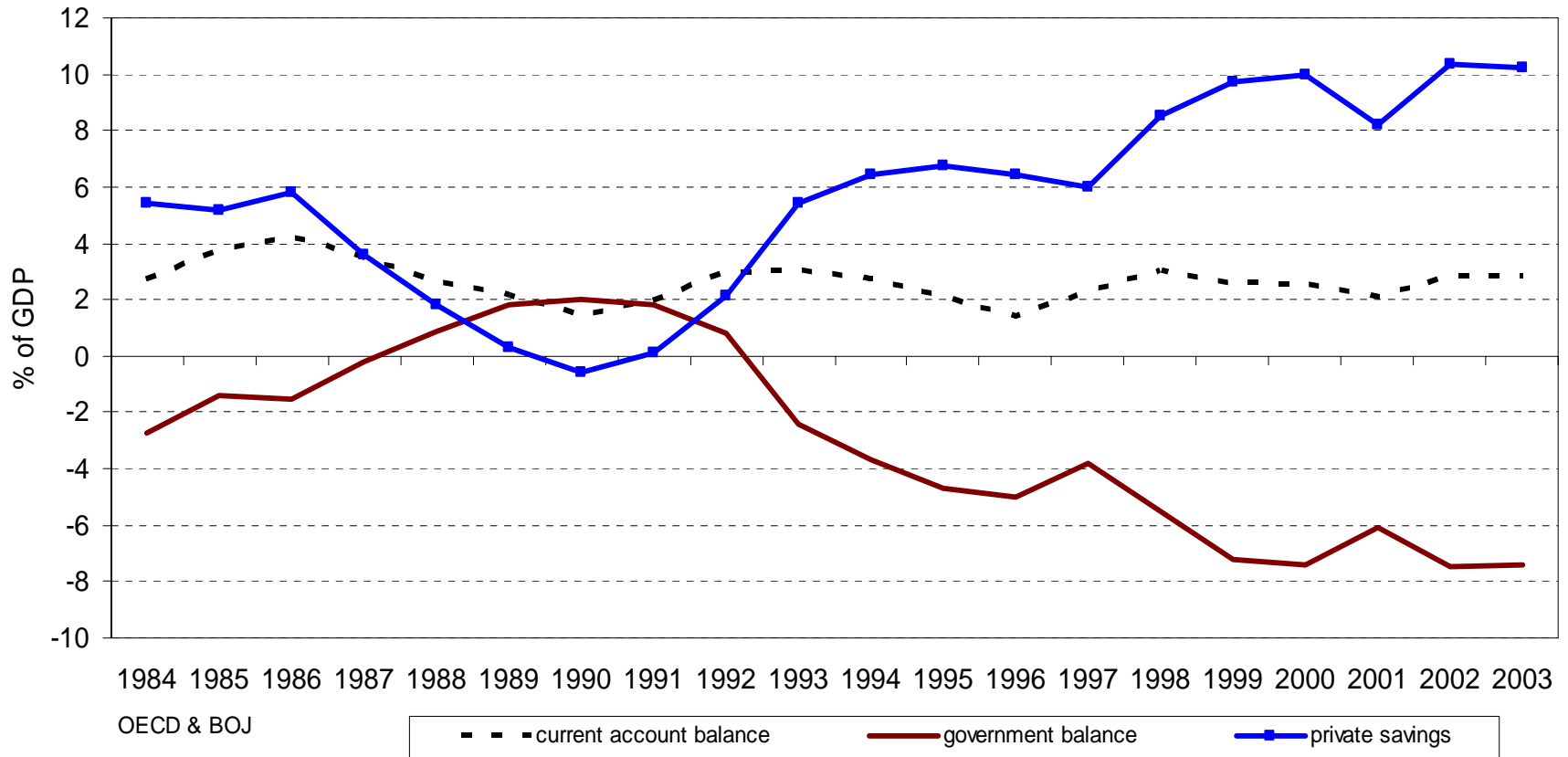
U.S. Consumer Durable/GDP

Volume in Percent

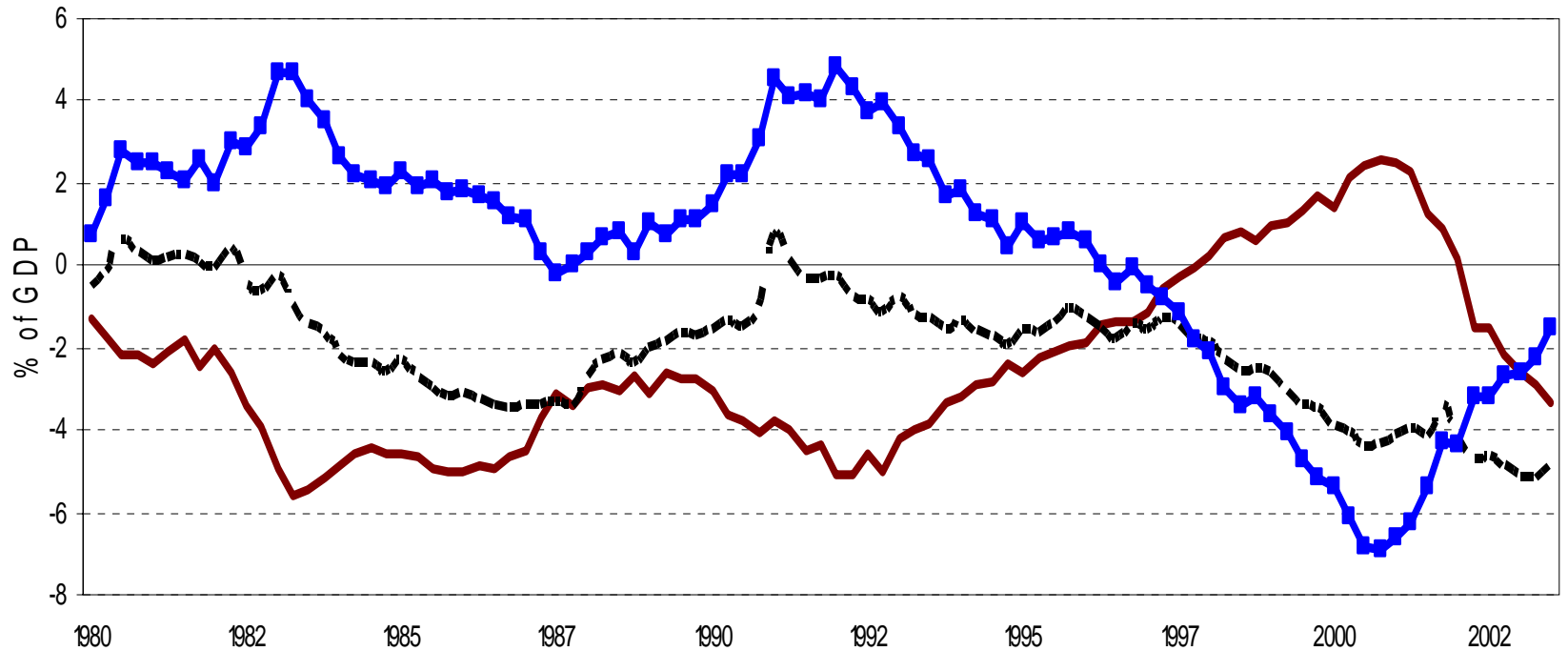


Data Source: Bureau of Economic Analysis

Japan (Fiscal Policy) Sector Analysis



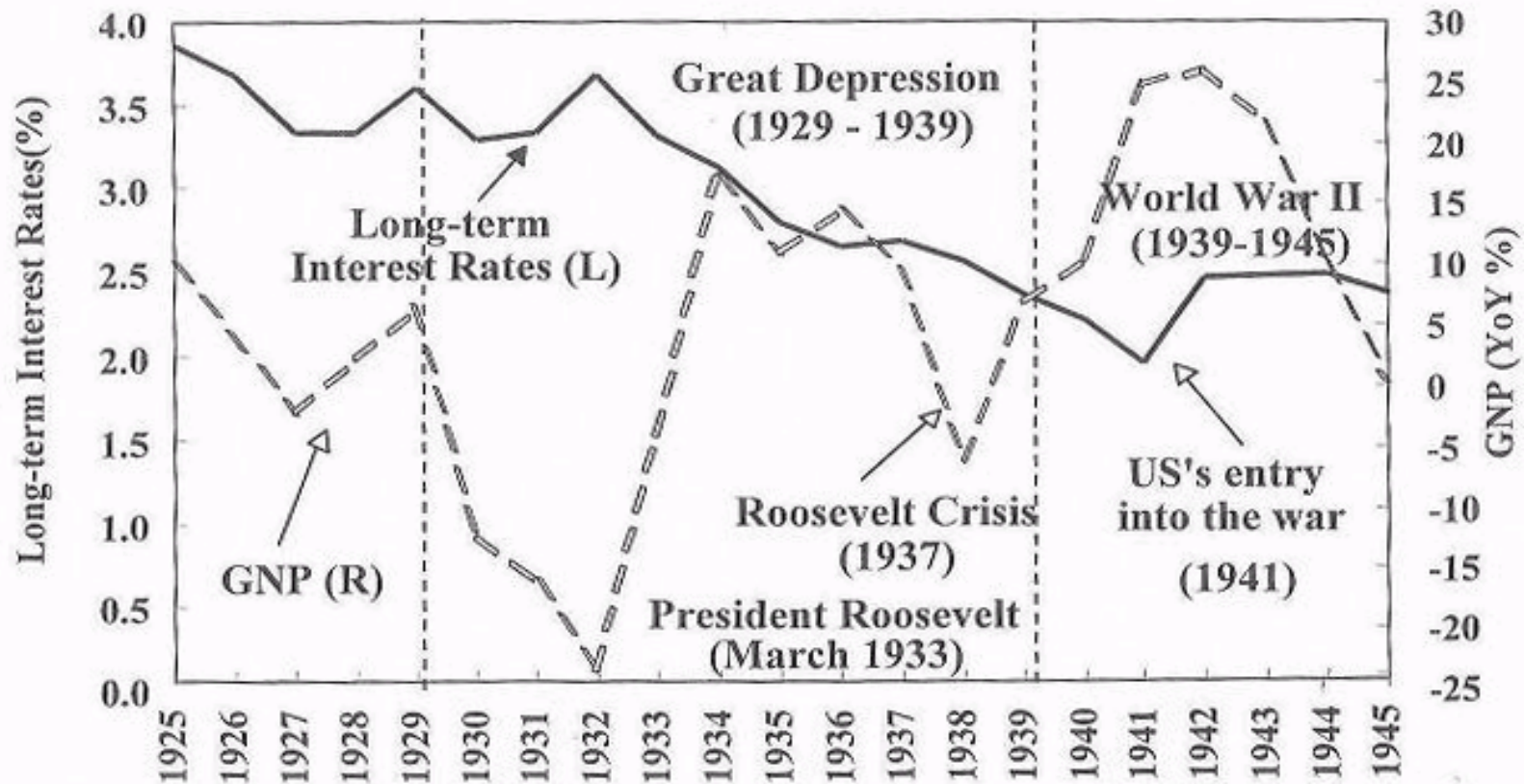
U.S. Sector Analysis



Source: BEA

— Government Balance - - - Current Account Balance —■— Private Balance

“Structural Reform Paradigm”: Great Depression In The U.S.



Notes
