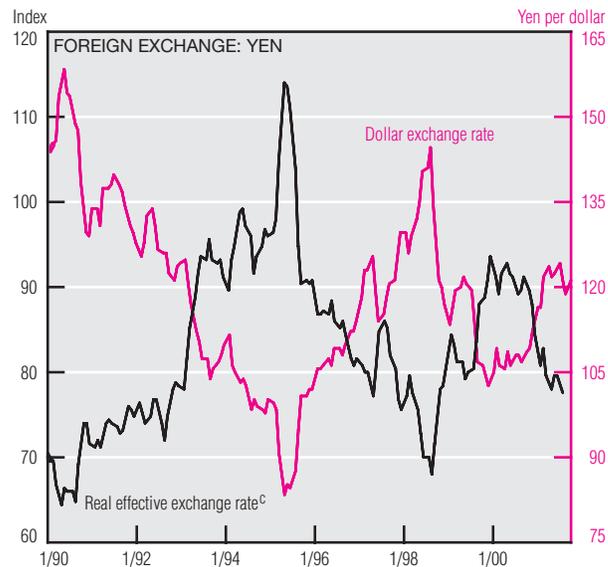
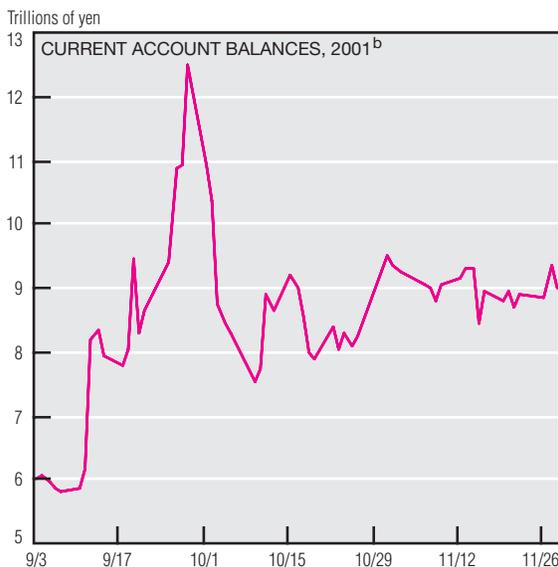
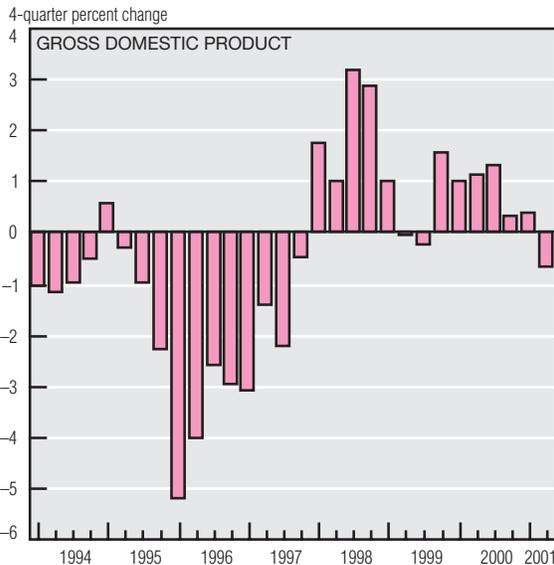


Japanese Monetary Policy



a. The temporary rise in Japan's CPI between mid-1997 and mid-1998 reflects the imposition of a broad-based 2% sales tax in 1997.

b. Current account balances are mostly commercial bank required and excess reserves held on deposit at the Bank of Japan.

c. The real effective exchange rate is a trade-weighted average of bilateral exchange rates between Japan's yen and the currencies of its major trading partners. Because it also adjusts for inflation patterns in each country, it provides a good indication of Japan's international competitive position. An increase in the index represents an appreciation.

SOURCES: Board of Governors of the Federal Reserve System; and Bank of Japan.

Japan's economy has contracted, and the price level there has fallen for much of the last decade. Prospects for a quick turnaround seem dim. Some economists believe that near-zero short-term interest rates and falling aggregate price levels have stymied monetary policy. They call on the Bank of Japan (BOJ) to announce an inflation target a few percentage points above zero and to pursue it aggressively, perhaps by financing a further fiscal expansion. The expectation of higher future inflation, these observers contend, would spur consumption and investment today.

They applauded the BOJ's decision last March to focus policy on the quantity of bank reserves it supplies instead of on short-term interest rates and to increase its holdings of government securities to achieve that target. Since September 11, the level of current account balances has jumped from Y6 trillion to about Y9 trillion.

Other economists contend that in an open economy with floating exchange rates, near-zero interest rates need not neutralize monetary policy. They want the BOJ to focus monetary policy on an exchange rate target and expand bank reserves by

buying foreign exchange (for example, dollars) instead of government debt. They believe that this would promote a yen depreciation, spur Japanese exports, and induce the nation's consumers to shift from imports to domestically produced goods. The Bank of Japan temporarily increased its current account balance to Y12.5 trillion in late September through foreign exchange interventions. Although the yen has depreciated recently, on a real effective basis it has appreciated since 1990.