RESEARCH BRIEF

Policy Uncertainty in Japan

Based on BFI Working Paper No. 2017-09, "Policy Uncertainty in Japan," by Elif C. Arbatli, economist, International Monetary Fund; Steven J. Davis, international business and economics professor, UChicago's Booth School of Business; Arata Ito, fellow, Research Institute of Economy, Trade and Industry; and Naoko Miake, economist, International Monetary Fund

KEY TAKEAWAYS

- ✓ Economic uncertainty is always present for firms and households
- ✓ This uncertainty, though, can be exacerbated when policymakers give mixed signals about their intent or otherwise surprise market participants
- ✓ Recent research on policy uncertainty in Japan reveals that surprise policy announcements can have a negative impact on macroeconomic performance
- ✓ To the degree possible, policymakers could try to limit the deleterious effects of policy uncertainty by operating within clear and well-understood guidelines

In the aftermath of the Financial Crisis (2007-08) and the Great Recession (2007-09), households and firms faced lots of uncertainty, not only about when and how the economy would recover, but also confusion on whether and how the administration, Congress, and the Federal Reserve would react. For families considering the purchase of a new car or a move to another city for a job, and for businesses considering new hires or a plant expansion, this policy uncertainty meant that the prudent choice was often wait-and-see.

Policy uncertainty is always a consideration for households and firms, even in relatively stable periods. In times of crisis or economic shocks, though, policy uncertainty is amplified and can, itself, have an outsized impact on the economy and fuel a sort of negative feedback loop. The US economy, and many throughout the world, has experienced a number of shocks in recent years that have raised policy uncertainty, including not just the recent crisis and recession, but also 9/11, the banking and sovereign debt crisis in the Eurozone, and two unresolved crises (at the time of this writing) that are roiling countries across the globe—the 2016 Brexit vote and the escalating trade wars—among others.

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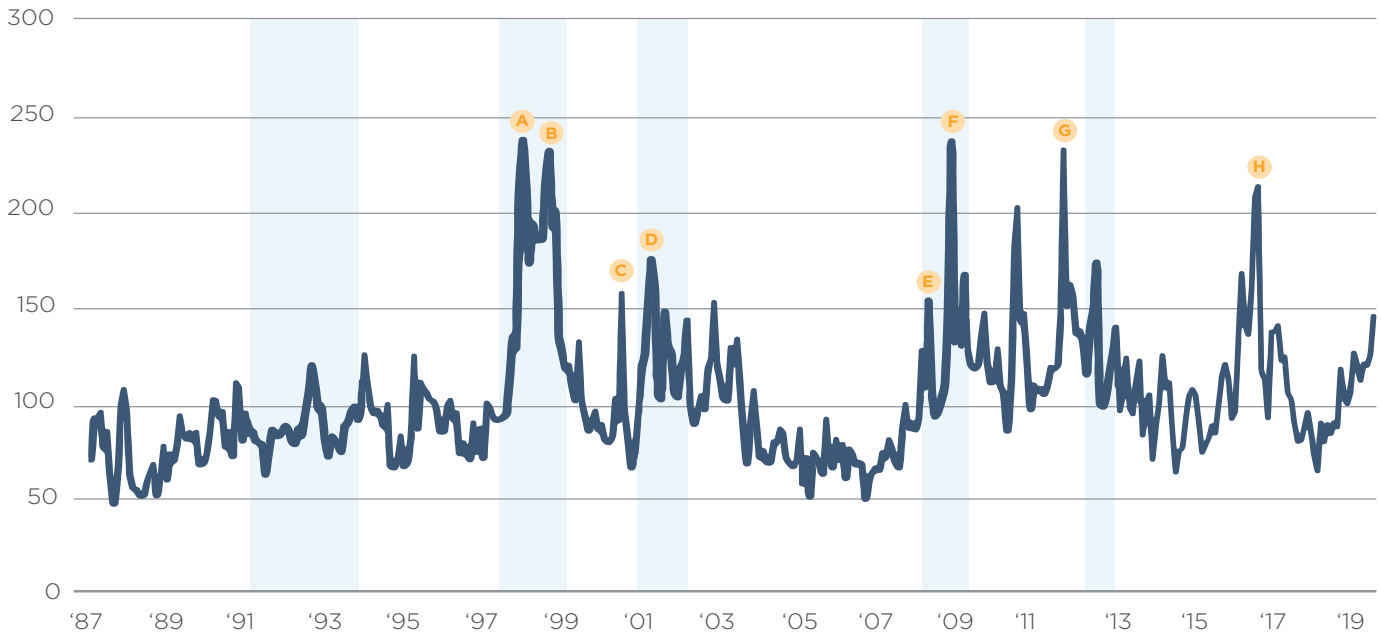
Figure 1 · Japan Economic Policy Uncertainty Index



Sources: Authors' calculations. Note: Shaded areas indicate recessions. Please see full paper for description of other events.

- **A** November-December 1997: Asian financial crisis, successive failures of banks and securities firms, and policy debates about fiscal consolidation.
- **B** July-August 1998: LDP's defeat in Upper House election yields Twisted Diet. Russian crisis.
- **C** June 2000: Lower House election.
- **D** February-March 2001: Political confusion over PM Mori's resignation. Introduction of Quantitative Easing.
- **E** March 2008: DPJ rejects BOJ Governor nominations.
- **F** September-October 2008: Lehman Brothers failure. BOJ cuts policy rate. Stimulus debate.
- **G** August 2011: U.S. debt-ceiling crisis. Concerns over European debt crisis. Further monetary easing. Japan FX intervention. PM Kan resigns.
- **H** May-June 2016: Consumption tax hike delay. Brexit referendum. Please see full paper for complete list of events represented in this figure.

Economists have attempted for years to measure policy uncertainty and its impact on economic activity, and chief among them is Steven J. Davis, international business and economics professor at UChicago's Booth School of Business. In recent years, Davis has authored or coauthored a number of papers on policy uncertainty and he has joined forces with colleagues from Northwestern and Stanford to develop a website (Economic Policy Uncertainty) to measure and track policy uncertainty around the world. A recent paper, "Policy Uncertainty in Japan," with Elif C. Arbatli and Naoko Miake of the International Monetary Fund, and Arata Ito of the Research Institute of Economy, Trade, and Industry, applies this analytical lens to Japan, a country mired in slow growth for twenty years or more.

Surprise! Here's your policy prescription

Weak economic growth in Japan over the past two decades—accompanied by stagnating wages and persistently low inflation, among other phenomena—has been blamed on such factors as changing demographics, external shocks, the zero lower bound of interest rates, and a number of policy mistakes. Davis and his coauthors investigate one factor that overlaps all of these phenomena—policy uncertainty.

While Japan's persistent economic struggles in recent years make it a useful example to study how policy uncertainty complicates economic decision-making, the country has also suffered from political swings that have further roiled the

economy. The country had six prime ministers in six years before electing Shinzo Abe in December 2012. Abe's election and his announced economic reforms, known as Abenomics, introduced a period of relative policy stability for Japan; the economy responded positively, with better growth and boosts in inflation.

However, such progress was short-lived. A number of policy proposals and actions quickly injected uncertainty into the economic mix:

1. Fiscal policy targets were perceived as not credible, in part because of frequent supplementary budgets;

2. A proposed consumption tax hike was postponed twice;

3. Changes in monetary policy and how such policy was executed sparked confusion;

4. And new ideas on labor, immigration, and trade policy, offered no clear path forward.

Regarding trade, Japan's economy (like many other countries) was dealt a blow when the United States withdrew from the Trans-Pacific Partnership in January 2017. In addition, the increasing trade tension between the US and China, with its sometimes daily swings in policy pronouncements, has spilled over to affect many other countries, including Japan.

> The US economy, and many throughout the world, has experienced a number of shocks in recent years that have raised policy uncertainty, including not just the recent crisis and recession, but also 9/11, the banking and sovereign debt crisis in the Eurozone, and two unresolved crises (at the time of this writing) that are roiling countries across the globe—the 2016 Brexit vote and the escalating trade wars—among others.

While it is one thing to note the presence of policy uncertainty, it is another to measure it. Davis and his colleagues developed a method to gauge policy uncertainty by tracking certain terms in major news media outlets over time; in this case they employed that strategy with four major Japanese newspapers from 1987 to the present. The methodology is described in detail in the paper, but in effect these many terms serve as a proxy for policy-related uncertainty among households and firms. If people and businesses are worried about a particular policy, for example, such a phenomenon is likely tracked in the news. Armed with this data, which forms the basis of their Economic Policy Uncertainty (EPU) index, the authors address three primary questions: How has policy uncertainty moved over time? Which policies account for the largest share of policy uncertainty? And does policy-related uncertainty have any predictive power for Japan's economy?

Overall, the Japanese EPU index peaked during the Asian financial crisis, in reaction to the failure of Lehman Brothers at the onset of the Financial Crisis, as US politicians argued about the debt ceiling, during Brexit, and over the recent deferral of a hike in Japan's consumption tax rate. The index has also risen during contested national elections and other major leadership transitions. Its fluctuations are moderately countercyclical, perhaps owing to policymakers' inclination to experiment with new policies during bad times.

Regarding different types of policies, the authors construct EPUs for monetary, fiscal, trade, and exchange rate policy. An increase in one tends to correlate with an increase in the others, but some of the indices have a more distinct relationship. For example, interest rate volatility correlates more positively with the monetary policy index rather than with the fiscal policy index. At 56 percent, most articles included in the EPU index reference fiscal policy uncertainty, with 24 percent referencing monetary policy, 9 percent trade policy, and 2 percent exchange rate policy. According to the authors, this suggests that fiscal policy is the source of the most policy uncertainty in Japan. Again, their methodology assumes that newspaper editors and reporters are writing about what readers care about. On that note, the EPU index shows a heightened increase in trade policy uncertainty since May 2018, with trade policy moving ahead of monetary policy as a source of uncertainty.

For all its insight on past performance, an important question is whether the authors' Japanese EPU index has predictive value for the country's future economic performance. The answer is yes: a surprise upward move in policy uncertainty foreshadows a deterioration in macroeconomic performance. Importantly, this effect may not be causal, and the magnitude of the connection is modest, but the authors stress that the result is strong enough to suggest that policymakers should pay attention. Injecting policy uncertainty into the economy, in other words, can hinder economic performance.

Conclusion

Economic uncertainty comes in many shapes and sizes, and also includes ambiguity caused by policymakers struggling to decide on a course of action or, alternatively, acting decisively and surprising markets with new rules that affect economic decision-making. To measure the effects of policy uncertainty, Arbatli, Davis, Ito, and Miake build on previous work to develop an economic policy uncertainty (EPU) index for Japan. Their work reveals that certain political events and economic shocks cause heightened policy uncertainty.

A key finding of this work is that a surprise upward move in policy uncertainty portends a deterioration in economic performance, including declines in aggregate employment, output, consumption, and investment. While this link may not not causal, and the effect is of modest size, this finding should give policymakers pause when considering how and when to enact new rules and regulations. One possible policy consideration would be for policymakers to adopt clear and well-understood guidelines for policy-setting, such that households and firms would have expectations in line with likely policy actions.

CLOSING TAKEAWAY

For all its insight that it provides on past performance, an important question is whether the authors' Japanese EPU index has predictive value for the country's future economic performance. The answer is yes: a surprise upward move in policy uncertainty foreshadows a deterioration in macroeconomic performance.

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NO. 2017-09 · SEPTEMBER 2019

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