Macroeconomic Effects of International Capital Flows: Lessons from Japan’s Foreign Reserve Investment

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The large increases in foreign capital flows into the U.S. caused by foreign central banks or oil-exporting countries have stimulated research as to their effect on U.S. interest rates. My thesis seeks to shed light on this topic by examining the relationship between Japan’s foreign reserve investment, which was propelled by its world record intervention, and U.S. interest rates. Additionally, I calculate the macroeconomic effects on the global economy due to the declines in U.S. interest rates caused by Japan’s foreign reserve investment. This research provides important lessons for understanding the current global economy, where large capital flows from China and oil-exporting countries influence macroeconomic variables through changes in asset prices.

1 International Capital Flows and U.S. Interest Rates (job market paper)

This paper investigates the dynamic relationship and the direction of causality between Japan’s foreign exchange policy and U.S. interest rates. I find that the declines in Treasury yields associated with Japan’s policy are temporary and hump-shaped, and that causality runs from Japan’s investment in securities to Treasury yields. Japan’s continuous investment held down long-term interest rates significantly and persistently from 2003 to 2004, with the maximum impact being 1.4% for March 2004.

2 Japan’s Foreign Reserve Investment and the Global Transmission of Interest Rates (in progress)

This paper examines the movement of interest rates in many countries when Japan’s foreign reserve investment causes U.S. interest rates to fall. I generally find that foreign interest rates decline, but not as much as U.S. interest rates. My estimation indicates that the resulting interest rate differentials between the U.S. and foreign countries put depreciating pressure on the U.S. dollar by making U.S. assets less attractive than foreign assets.

3 International Capital Flows and the Dynamics of Output and Inflation (in progress)

This paper calculates the macroeconomic effects of Japan’s foreign reserve investment quantitatively using a modified version of the three-country model constructed by Coenen and Wieland (2002). Preliminary results suggest that the declines in long-term interest rates could have stimulated the U.S. and the euro area economies, but had little impact on the Japanese economy. These results contrast sharply with the literature, where Japan’s foreign exchange policy is considered as only having a beggar-thy-neighbor effect.