

On a Comparison of Alternative Specifications of Highly Interest-elastic Money Demand under a Liquidity Trap in Japan

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ABSTRACT. This paper conducts a predictability comparison between the semi-log and log–log specifications of money demand in Japan, thereby assessing their implications for the presence of a liquidity trap, or a situation in which monetary policy becomes ineffective at near-zero interest rates. We find that the semi-log specification which incorporates the emergence of higher interest-elastic money demand in the mid-1990s produces superior prediction during Japan’s zero interest-rate regime from 1999 to 2006. Our finding implies that the presence of a liquidity trap does not necessarily involve as considerably high interest-rate semi-elasticity as the log–log specification has in the zero interest-rate regime.

JEL classification: E31, E41, E52.

Keywords: money demand, zero interest-rate policy, liquidity trap, structural break, predictability comparison, bootstrap.

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