Currency Kabuki
By R. Glenn Hubbard
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Pop quiz: Country A is spending tens of billions of dollars to avoid letting its currency appreciate against that of Country B, which eschews intervention. In which country is monetary policy too tight?

As you might guess from the news, Country A is Japan, and Country B is the United States. Some in the U.S. have expressed concern that repeated Japanese currency interventions are unhealthy for the U.S. and the global economy. In Japan, there is a realistic fear that an appreciating yen will choke off the fledgling recovery. A deeper issue missing from the conversation is that monetary policy is too restrictive in Japan, reducing Japanese growth and collaterally damaging the U.S. and global recovery.

The clear sign that monetary policy remains too tight is the continuing deflation and expectation of deflation in Japan. Deflation is not an abstract enemy of economists. It can be an economic cancer. High real interest rates and mounting real debt burdens in a deflating economy sap business performance and tax entrepreneurship and dynamism. The high real returns from holding cash further retard willingness to hold riskier, more productive assets. Deflation also weakens consumer spending by leading households to postpone purchases.

Back to currency interventions. Japanese currency interventions are not likely to assist the Japanese economy as long as they are sterilized. (In a sterilized intervention, the central bank conducts offsetting transactions to leave the monetary base unchanged.) While anecdotal evidence seems to indicate that recent Japanese currency interventions have been unsterilized -- thereby contributing to monetary expansion -- the data are not so clear. In any event, a strategy of monetary expansion through a series of ad hoc unsterilized interventions is not the best way to advance the expansionary policy Japan needs.

Bank of Japan Governor Toshihiko Fukui has commented on several occasions on the need to restore a reference price level in Japan. The BoJ could define the price-level gap it wants to make up, and announce that it will undertake any and all measures to achieve this reflation. The precise tactics are less important than articulating the strategy. But follow-through will be essential. Stop and go policies toward operating targets should give way to more aggressive expansion.

A sustained, credible monetary expansion in Japan to restore price stability may well weaken the foreign-exchange value of the yen in the near term (consistent with the objective of the ad hoc interventions). But the reflationary monetary policy importantly will reduce the many effective tax burdens deflation exacts from the private economy. The longer-term effect on the yen's value is ambiguous because a vigorous, recovering Japanese economy may, all else being equal, result in a stronger currency.

A popular reading of the recent G7 finance ministers' communique in Dubai is that it focuses on exchange-rate policy. An alternative reading -- which I prefer -- is that the communique emphasizes that the major economies of the world should adopt policies that promote economic growth, importantly including domestic demand growth.

This reading is consistent with President Bush's emphasis on the promotion of economic growth in the U.S., in the G7, in emerging economies, and in the poorest economies. It is in the economic interests of the U.S. -- as well as Japan -- for Japan to return to price stability and economic growth. The applause for a global recovery requires more than one U.S. hand clapping. Pro-growth policy in Japan is important.

Japan and the U.S. are allies and friends in values, national security, and commerce and finance, and our leaders will meet again soon. In economic policy, a zero-sum game of currency intervention can give way to a positive-sum game of Japanese reflation and global recovery.

Monetary policy alone, of course, cannot fundamentally alter Japan's long-term growth prospects. Economies grow and prosper because of the productivity and innovation of businesspeople and workers. At the micro level, it is encouraging to see corporate restructurings and banking reform proceed; rejuvenating the process by which capital is allocated lies at the heart of improving Japanese economic performance.

Yet monetary policy has its supporting role in this process. A commitment to low but positive inflation by the BoJ would enhance the cyclical recovery under way in Japan and improve the chance of better long-term growth prospects. In short, a win-win policy for Japan and the U.S. is achievable.

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