Deflation and Monetary Policy in Japan
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I agree with a fair amount of Professor Ueda's analysis, but I disagree strongly about how much the Bank of Japan (BOJ) is to blame for the malaise in the Japanese economy right now and also what the central bank and Japan should do. First, I will talk about what I agree with.

The first issue that Professor Ueda raised is that mild deflation by itself is not a disaster, and this is not the same kind of deflation that we saw in Japan and the United States in the 1930s. I should point out that we have not had a depression in Japan of the type that occurred in the U.S. in the 1930s. Japan has had a very anemic growth rate over the past ten years or so, but we have not seen a collapse of the Japanese economy.

Professor Ueda mentioned that the big problem is what I like to call a "creeping financial crisis". The financial sector is in huge trouble with very weakened balance sheets, and this means that businesses that are very dependent on bank lending have been doing very poorly. In fact, what you see is a bifurcated Japanese economy in which bank-dependent businesses are languishing while large exporters who have access to international capital markets are doing well. So I strongly agree with Professor Ueda that this is a key problem.

Another point that Professor Ueda mentioned is the need for structural reforms in Japan. I also agree with him that a key issue is the problems in the banking sector and also in other parts of the financial sector.

I also agree that the BOJ cannot solve all of the problems and there is no question in my mind that without a banking and a financial sector that it is efficient in getting capital to people with productive investment opportunities, the Japanese economy can never reach the growth rates that it should reach. You may recall that it was only approximately ten years ago when everybody talked about the Japanese overtaking the U.S. economy. Actually, this was something that could have happened. I think that there are tremendous inherent strengths in the Japanese economy, but it is being held back. At any rate, I think that this is very important.

Professor Ueda also mentioned that many people try to blame the Bank of Japan for being the initial cause of these problems. I agree with him that this view is incorrect. The initial cause was a bursting of the asset price bubble. There were serious problems in the prudential supervision of the banks that helped lead to this kind of bubble and then when the bubble popped it created some serious problems.

However, there are two areas of Professor Ueda's discussion that I strongly disagree with. First is that the economic malaise in Japan is not the Bank of Japan's fault. Second, that the BOJ really cannot fix the problems or help the economy recover from these troubles.

I think that the BOJ has made it much more difficult to solve the financial sector problems. The BOJ has also made it more difficult to get the structural reforms that the Japanese economy needs to get its growth high again.

Within this context, let me talk about the issue of monetary policy and asset prices. One of the points that Professor Ueda talked about was that monetary policy cannot do a whole lot about asset prices. Also he claims that deflation itself is not what's really hurting asset prices: the problem is that asset prices are just too low, and they are still declining, as is the case for land prices.

I disagree because the real issue is what the Central Bank can do about aggregate demand. One of the reasons that asset prices are so grim in Japan is because there are expectations that the monetary authorities are either not capable of or will not try to actually expand aggregate demand sufficiently to make it possible to make big profitable investments. When you are in a deflationary environment where your expectation is that this Bank of Japan either can't stop the deflation or won't stop it by pursuing sufficiently expansionary monetary policy, then you really have problems. One view is that the BOJ may not be able to stop the deflation, but I think there is another view, which is that the BOJ actually has one of the most peculiar credibility problems among central banks throughout the world right now.

Usually we worry about central banks having credibility in terms of keeping inflation low so that there is always a concern that they will pursue job creation through expansionary policy that will lead to inflation. I think the BOJ has the opposite problem. They have very little credibility with regard to their willingness to continually pursue expansionary policy for a sufficient period to get the economy rolling again. In particular, I think this had a lot to do with the previous governor of the BOJ who focused on the horrors of inflation and very little on the dangers of deflation. Furthermore, when the BOJ pursued expansionary policy, they would take it back. For example, the BOJ

pursued a zero interest rate policy for a period of time, and then when the economy started to perk up they raised interest rates again.

This has led the BOJ into a trap. If there are expectations that when monetary policy is expansionary, it will be taken back, then it is not going to be as expansionary as the monetary authorities would like. Indeed, the BOJ finds itself in exactly this situation. The markets clearly take the view that the BOJ is not willing to pursue expansionary policy for a sufficient period of time to make sure that the economy will come back strong again.

I think that the BOJ is in a situation where, as Franklin Delano Roosevelt said during our Great Depression, the only thing they have to fear is fear itself. The BOJ is very reluctant to take what they see as risks, which as I see it are not great risks because the thing they need to fear is not inflation but is deflation.

In this case, I think the BOJ has to achieve reflation and do it with both words and actions. By words, I mean establishing an institutional framework that actually indicates what the central bank will do over a longer period of time. This is important because the key to effective expansionary policy is what you do to expectations. The BOJ needs to do two things. First, it needs to indicate that it is going to reflate the economy by making very strong efforts to get the price level back to where it would have been in the absence of deflation. Second, once this reflation is achieve they should then adopt an inflation target of approximately two percent. The reason for the inflation target is to protect the BOJ against fears of having uncontrolled inflation. What we have seen is that credibility for price stability is created not just by keeping inflation low, but also by not keeping inflation too low. That is what we mean by price stability. This is a very

important issue and, in one sense, inflation targeting is an institutional framework that needs to be used by the BOJ to get out of their expectational trap.

What measures does the BOJ have to take to do this? Professor Ueda made two points. One is that monetary policy is not as effective as it was. However, does that mean monetary policy should not be used to get aggregate demand back up? I think the answer is no, and the BOJ just needs to be that much more aggressive and push harder. Indeed, there are many other measures that the BOJ can take, such as open market operations in other assets like long-term bonds. Their interest rates can be driven even further down. There is also the issue of equity prices and the FX market. Open market operations in these asset markets can help produce asset price changes that would be helpful in terms of getting the economy going again. Part of the reason I think the BOJ has been very reluctant to do this may have to do with their discomfort about the degree of independence they have.

One of the statements that Professor Ueda made was that expansionary policy would be at odds with the reform process. He does see that structural reform particularly in the bankruptcy sector is critical, and I would agree. However, I take the view that expansionary monetary policy is exactly what is needed to get the reform process going. For example, I would not have characterized the bank restructuring process in Japan the way Professor Ueda did. He characterized the government as doing the right thing but just not at the right time. They did not do the right thing. They injected capital into the banking system, but they did it as a half-measure with only a partial recapitalization of the banking system while allowing weak banks to remain open. We know, for example, that a half-measure is the worst thing to do. One must fully recapitalize the potentially

healthy financial institutions so they start lending again. Half measures just leave bad banks in operation and do not stimulate the lending process.

Bank restructuring has not happened because the banks are politically powerful and they are in a situation where they can say, "if you close us down it is going to hurt the economy". This is exactly a case where active monetary policy to pursue very expansionary policy can help the process. If restructuring the banking system would initially weaken the economy, monetary policy can help overcome this weakness by stimulating the economy.

The second issue is structural reform. In order to do structural reform there needs to be investment. I see structural reform as less a problem for the business cycle issues in Japan but very critical for long run economic growth. It is not acceptable for Japan to have a GDP growth rate one percent per year. It is clear that they should have numbers very similar to the United States and I would argue that there is even the potential for Japanese growth to be higher than the U.S.

Having very expansionary monetary policy will raise asset prices, will end the deflationary psychology in Japan and would actually be a tremendous help.

In conclusion, my view is that it is true the BOJ is in a very difficult situation. On the other hand, in a difficult situation you do not want to fight the last war, but want to fight the current one.