On Monetary Policy:
Yap at Japan, Not China

By MICHAEL COSGROVE
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Milton Friedman once suggested that the Hippocratic principle be applied to those responsible for monetary policy -- "Do No Harm." There must have been a translation problem for Bank of Japan officials. The Nikkei stock index reached a peak monthly value of 38,134 in December 1989 before declining to 7,909 in March 2004 -- its 1982 level. That equity decline is a useful proxy for Japan's economic deterioration from an economic powerhouse to an economy depending on exports to the U.S. and emerging-market economies for its growth. Japan's economic growth has been anemic since 1990 -- averaging approximately 1.5% per year, while inflation, as measured by the CPI, has averaged about zero.

What happened? It appears the BOJ downshifted the growth of monetary aggregates. Growth in M2 plus certificates of deposit averaged approximately 11% per year in the 20-year period prior to 1990 while averaging only about 3% since 1990. Perhaps a better measure of central bank actions, the monetary base or high-powered money averaged nearly 10% per year before 1990 and approximately 7.5% since. Growth in the monetary base plus an overnight rate of less than 1% since 1995 and nearly zero since 1999 led many to think that BOJ officials were following an accommodative monetary policy.

In 1999, Fed Governor Ben Bernanke wrote, "The argument that current monetary policy in Japan is in fact quite accommodative rests largely on the observation that interest rates are at a very low level." He went on to say that "low nominal interest rates may just as well be a sign of expected deflation and monetary tightness as of monetary ease."

Japanese households and businesses have a demand for cash after years of decline in land prices, a falling Nikkei and no inflation -- in fact deflation -- at the consumer level. Japanese households expect more of the same -- so they hold cash. Growth in the monetary base is reflective of BOJ officials attempting to meet the demand for cash balances by households. But since inflation remains stuck around zero, it is obvious that BOJ officials have not yet met the demand for cash that is consistent with positive rates of inflation.

Many observers thought BOJ officials had finally realized what they needed to do when in March 2001 they announced their quantitative monetary policy easing program. In implementing that policy, the BOJ conducted open market operations to increase "its balance of current bank accounts held at the BOJ." It was expected that BOJ officials would alter expectations concerning the wisdom of holding cash through its quantitative easing program by creating positive rates of inflation. Initially it appeared that the BOJ might do that, but real growth in Japan remains anemic and inflation is stuck around zero. Unfortunately, it appears that expectations about the value of holding cash have not been modified.

Nonetheless, Toshihiko Fukui, governor of the Bank of Japan, gave a talk on May 13 in which he appeared to think otherwise. "The economy is expected to experience a relatively long period of growth," he said. He went on to explain that Japan is currently experiencing a "temporary pause" in growth. Mr. Fukui also believes that "both the economic and financial fundamentals have been strengthening." That helps to explain Friday's policy shift allowing bank reserves to dip below 30 trillion yen, which some have seen as a sign of future BOJ tightening.

It's true that the monetary base grew rapidly in the early stages of quantitative easing, which led observers to expect that the BOJ was serious about achieving a positive rate of inflation. But growth has been slowing significantly and currently averages 2% to 3% on a year-by-year basis -- a tepid pace that spells intermittent periods of recession and deflation ahead.

Fortunately, there is a way out of this 15-year period of economic malaise. Mr. Fukui should set an explicit target for CPI inflation of 2% to 3% or some other positive rate of inflation and state that the BOJ will retire government debt until that inflation range is achieved. The BOJ has the power to change inflationary expectations as there is no limit on the amount of money the BOJ can issue and they can purchase government debt if they so choose.

Japan's gross public debt is 160% of its GDP. If necessary to achieve their targeted inflation rate, the BOJ can buy all of that debt. In theory, Japan could end up in the enviable position of having zero public debt. In that process of reflation, however, the BOJ needs to allow the yen to find its equilibrium level, which means allowing the yen to devalue.

A cheaper yen would mean foreign capital inflows as U.S. and Chinese investors and businesses rush in to purchase Japanese real and financial assets. Since the Chinese currency is pegged to the dollar, both U.S. and Chinese investors would be like kids in a candy store with lots of money. That has been the nub of the issue for the past 15 years. Japanese officials are afraid to straighten out their economic mess because it would mean allowing the yen to find its own level, which in turn would mean a flood of foreign monies pouring in to scoop up undervalued assets. Japan has manned the battle stations for 15 years to minimize foreign investment inflows. Remember when one dollar could buy 270 yen in 1982? Now it can buy only around 107. Japan wants a strong yen to keep foreign investment out and seems willing to indefinitely make the trade-off of remaining in or near deflation and stifling their economic growth with inadequate money-supply growth to achieve that.

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Meanwhile, members of Congress and the Bush administration are barking at the wrong country -- China. China's currency is pegged to the dollar so that Chinese monetary policy reflects Federal Reserve policy.

Japan is the problem. Japan will not adopt a monetary policy that is conducive to faster economic growth which would pull in more imports. Likewise it will not adopt a tax policy that is conducive to economic growth and more imports. The Bush administration and Congress need to start yapping at Japan. Let the Chinese alone on monetary policy. Washington has plenty of other issues to press the Chinese on -- issues that the Chinese could more easily act on.

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