Japan's Targeting Dilemma

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The battle between Japan Inc. and the Bank of Japan is heating up. For years the bureaucrats at the Ministry of Finance have been trying to bully bank Governor Masaru Hayami into expanding the money supply more aggressively to halt deflation. Now members of parliament from the Liberal Democratic Party are trying to pass a law by next month that will force the central bank to set inflation targets and then meet them within a specified time. That will require drastic action and is likely to have harmful unintended consequences.

As any economist will tell you, Japan is going through some strange times indeed. A couple weeks ago we learned that the country has been suffering from deflation for two full years, which is unusual enough. This happened despite the fact that the rate of interest at which the Bank of Japan lends money to banks has been zero or just fractionally above zero during this period, and the BoJ has in fact been pushing banks to borrow.

As a result, the money supply has been growing, yet GDP, nominal and real, is now falling, two things which hardly ever happen simultaneously for any length of time. The simplest way to explain it is the velocity of money, the rate at which it passes from one pair of hands to the next in the millions of transactions that reflect GDP, is slowing.

So why is this so? In any economy, after an individual person or company puts money in the bank, it is quickly lent out again. This borrowed money might be left sitting in the bank for a while, or it might be spent either on investment or consumption. Either way, it makes its way back to the banking system, and is lent out a second time. This happens over and over again, a phenomenon known as the multiplier effect. In normal circumstances, central banks monitor how many times this happens, so when they put more money into circulation or take some out, they can be reasonably certain of the effect it will have on the total money supply.

Nothing is normal about present-day Japan, however. Pessimistic businessmen are less and less eager to invest and worried consumers are reluctant to spend. Meanwhile because the banks are still swamped by bad loans, they are putting aside capital to write off losses and investing in less risky government bonds. The result is that credit creation, the engine of economic growth, is working in reverse. The Bank of Japan is pumping out more money, but the money multiplier is decreasing. Hence the shrinking economy.

As Mr. Hayami has never tired of saying, the only way to fix this is to undertake structural reform. Banks are the transmission belt by which monetary policy influences the economy, and that belt is broken. Fixing it will take tougher action by the bank regulators at the Financial Services Agency and the bad loan disposal experts at the Resolution and Collection Corp. to restore banks' balance sheets to health. Because of the magnitude of the problem, corporate restructuring is proceeding on a parallel track, with thousands of workers losing their jobs.

Supporters of the inflation-targeting legislation say that it will give the economy a quick boost by creating inflationary expectations. According to this thinking, the belief that deflation will continue has become a self-fulfilling prophecy. That's because people generally defer spending and avoid borrowing money, which in turn forces prices lower. If Japanese became convinced that inflation was starting, they might also start moving up their purchases, ending deflation.

But it's worth asking whether Japan's deflation is really primarily a psychological problem. Sure, layoffs and the prospect of higher taxes in the future to pay off the national debt must have some impact on demand. But it's hard to say this has a greater impact than some other one-time changes that are occurring. For instance, the economy is now more open, meaning that cheaper goods are coming in from abroad. Industries that suffer from excess capacity are cutting prices to the market-clearing level. But a generalized deflation like Japan is experiencing is a monetary phenomenon, which means it demands a monetary cure. That leads us back to the broken transmission belt, the banks.
The Bank of Japan could create inflation by buying non-government assets like stocks, as the proposed law envisages. But Mr. Hayami warns that once started, inflation could be difficult to control. All that money that has been sitting around quietly could become hyperactive. Facing accelerating inflation, it’s rational to put one’s wealth into real assets, but when everyone attempts to do so at once, prices rise even faster. And since inflation favors borrowers, businesses and individuals would suddenly develop an appetite for credit, pushing up the money multiplier and begetting more inflation.

It’s hard to say how things would play out from there. Bond prices would fall and yields would shoot up, punching a new hole in banks’ balance sheets. The government would have to pay more to finance its deficit spending. The BoJ’s new-found independence would be history, creating uncertainty about what targets politicians and bureaucrats would set for monetary policy. Both Japanese and foreigners would re-evaluate the safety of Japanese assets, with unpredictable consequences.

What is clear is that the Bank of Japan would end up owning a lot of assets that belong in private hands. And the process of unravelling the frothy investments of Japan’s bubble years would come to a halt. Inflation essentially transfers a society’s wealth from the savers to the borrowers. The families who scrimped and saved would be left with a fraction of their nest egg, while those who ran up huge debts speculating on Tokyo real estate might even find themselves back in the black. Putting aside how this would distort economic decision-making, Japan’s orderly, consensus-driven society would be devastated. To be sure, inflation would devalue Japan’s huge national debt, which may explain its political popularity. But debt holders, that is to say the public, would pay for that.

Prime Minister Junichiro Koizumi had it right when he told voters that Japan would have to endure more economic pain before things get better. True, his half-hearted bank reform program hasn’t provided much reassurance that Japan will emerge from the other side any time soon. And he could do much more to encourage the animal spirits of the economy, for instance by cutting taxes and making it easier for entrepreneurs and risk capitalists to operate. But unleashing inflation without addressing these measures first is no quick fix. Any attempt by the LDP to legislate the Bank of Japan into a stock-buying spree is a risk better left untaken.

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International Commentary

Japan’s Deflating Morale

Your Nov. 6 editorial on deflation in Japan, "Japan’s Targeting Dilemma," confuses both the risks and benefits from aggressive monetary stimulus. All the examples of modern industrial countries that have suffered through prolonged deflation involve terrible macroeconomic performance. This is true now in Japan and continuing deflation will lead to continuing poor performance.

It is true as you argue that the problems in the banking system have made it hard to reflate. But failure to stop the deflation has exacerbated the banking problems: With falling prices even the low nominal interest rates you cite still involve substantial real interest rates. These real interest rates are an important factor impairing borrowers’ abilities to repay their loans. An aggressive monetary expansion by the Bank of Japan would help the banks by lowering their customers’ real debt burdens (and raising the value of collateral). This is the main reason for favoring a monetary easing.

The main risk you identify from monetary expansion, "that inflation could be hard to control," is extremely doubtful. There is no evidence in recorded history where a country has gone from deflation to rapid inflation. This never happens for good reason: In a country experiencing anything like what we have just seen in Japan it is going to take quite awhile before price-setters’ main concern is that the currency has been debased.

If the money supply was expanded until the deflation stopped, it is true that there might be a brief period of sizable inflation, perhaps even as high as 5 to 10%. But this is likely to be helpful. We all agree that an important cost of inflation is the arbitrary wealth transfer that it generates for parties that had undertaken long-term contracts. In Japan the unexpected deflation has had the same effect, making some debt obligations far more burdensome than was anticipated at the outset of the contract. Therefore a period of moderate inflation would likely restore the price level to a path that most parties had anticipated. In the worst case, if the inflation does persist, it could be contained by a conventional tightening of policy.

These observations do not imply that there are no risks or costs to aggressive monetary expansion. In the course of growing the money supply, the Bank of Japan will end up owning some assets. If they buy foreign assets directly they will be accused of trying to export their way out of recession. In the current environment they are likely to come under intense criticism from many of Japan’s trading partners. If they buy domestic assets, such as equities, then they become a shareholder and risk interfering with corporate governance and perhaps impeding the restructuring that is rightly needed. Furthermore, the domestic purchases will likely engender a large depreciation.

These costs are legitimate -- although the concerns over the exchange rate would have been much lower two years ago when the world economy was booming. But the alternative to not acting is to continue to watch as the deflation contributes to the deterioration of the economy. As the economy implodes the country continues to issue debt and at some point the risk of having to inflate that away will become severe. This more conventional mechanism for producing high inflation is much more dangerous than the one that Mr. Hayami identifies.

Finally, it is also unfortunate that the politicians are attempting to trample the central bank. An independent central bank is generally an important ingredient in arriving at good macroeconomic policy. But a central bank that presides over several years of deflation deserves to be criticized. The sooner the BoJ admits that it could stop the deflation and begins taking steps to do so, the sooner will it command the support of mainstream macroeconomists against the politicians.

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