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Personal View: Richard A. Werner
***Central Banks:* DON'T LISTEN TO WHAT THEY SAY - WATCH WHAT THEY DO**

Despite its denials, the Bank of Japan is fully in control of the amount of credit that it injects into the economy. Currently, it is *reducing* credit creation.

Chart: Net credit creation of the Bank of Japan (BoJ Leading Liquidity Index, Source: Bank of Japan, Profit Research Center Ltd.)
***Definition:** Growth rate of net monthly transactions of the central bank, indexed.

In his article on Japanese monetary policy, Mr Kunio Okina of the Bank of Japan denies that the Japanese central bank could or should go beyond its current 'zero interest rate' policy to stimulate the Japanese economy (*Financial Times*, Personal View, 12 August). Mr Okina argues that a comparison with the 1930s in the US is invalid, as the Japanese money supply has been growing significantly in recent years. Further, he feels that it is not possible to increase cash in circulation, because demand for cash has fallen. Even if one could increase cash in circulation, he goes on, this would not increase 'the money supply', because bank balance sheets have been eroded. The BoJ should also not increase bond purchases, as this could 'subject the Bank of Japan to huge market risks', so that 'investors at home and abroad would lose faith - not only in the bank, but also the Japanese economy'. He concludes that the BoJ is already making "utmost efforts"to boost the economy.

Mr Okina's case re-inforces the old rule about central banks: Don't listen to what they say - watch what they do. His reference to the rising 'money supply'is a good example. The fact that the BoJ's key measure of the 'money supply', M2+CD, has been rising during much of the 1990s is irrelevant. M2+CD is not well-correlated with economic activity. Not surprisingly so. It is an arbitrarily chosen sub-set of private sector savings that, like other M-measures, should be correctly named 'savings supply'. An accurate measure of the money supply is based on an aggregate of central and commercial bank credit creation - and that has been shrinking for much of the 1990s, just like in the 1930s in the US. A US-comparison is indeed relevant, because in both cases long recessions were caused by a central bank that stubbornly argued against quantitative reflation via bond purchase operations funded by money printing. Mr Okina's very argument is highly reminiscent of the excuses made by the Fed in the 1930s, when US citizens were starving while the Fed failed to do what it was created for in 1913 - namely to step in, print money and bail out banks when necessary.

As for his argument that the central bank can't print more money because there is no demand for it - sure, and the moon is made of cheese. Money is special in that there is always demand for it. I will certainly volunteer to name my bank account and accept unlimited amounts of money from the BoJ. The amount of purchasing power in the economy can always be increased by the Bank of Japan via purchase operations of bills, bonds and dollars, paid for by newly created money. Such money creation and purchase operations are necessary *precisely when* banks are not doing their job of creating credit via lending (as bad debts render them risk-averse). Mr Okina's view that the central bank can't increase credit creation in times of financial instability puts the cart before the horse. Whenever else, if not in times of financial instability, is there a need for central banks to print money aggressively?

What happens to the BoJ's balance sheet as a result of bond purchases paid for by credit creation should be of no concern. A central bank need not worry about its balance sheet, as long as it has enough foreign exchange reserves, and that is the case in Japan. No investor will short the Japanese stock market on the basis that the BoJ has *increased* money printing aggressively. But the fact is that the BoJ is currently *reducing* its net credit creation (chart). That is bound to be a bigger concern for investors. Further, Mr Okina should be more worried that investors will lose faith in the BoJ and the Japanese economy, if BoJ staff continue to obfuscate the truth about their actual policies. Throughout the 1980s, for instance, the Bank of Japan has claimed that its direct credit controls over bank lending had been abolished. New academic research has, however, proven that it continued throughout the 1980s and was, indeed, the very mechanism that created the bubble. But the good news for investors is that Mr Okina heads the Institute for Monetary and Economic Studies at the BoJ and hence is far removed from policy decision-making. The institute is staffed by economists trained at overseas universities in neo-classical economics (the branch of economics that argues that money has no influence on the economy). Its purpose is to inform the public about the good work being done by the Bank of Japan. But its partisan views are unlikely to be shared by independent observers, not to mention the almost five million unemployed in Japan.

But the key question remains: if it has been so easy to create a recovery - all we needed was BoJ bond purchase operations and money printing - why has the BoJ remained in a perpetual state of denial and has, until 1998, not taken any reflationary policies? Mr Okina's last sentence allows a glimpse into the true motivation of the BoJ: He climaxes his article with the ultimate denial, claiming that the key for a recovery is anyway not monetary policy, but structural reform. Hardly. If the economic structure really created the recession, how come the same structure had created 50 years of spectacular growth before the 1990s? But his claim is revealing for other reasons: the truth of the matter is that the BoJ could have created a recovery as early as 1992. But it chose not to. Why? In the words of a key BoJ member of staff, who is close to policy-making: "What Japan needs now is structural reform, not a recovery. If we create a recovery, nothing will change."Thus spoken in 1992. Thanks to the long recession, Japan's structure has indeed begun to change dramatically. The greatest loser has been the Ministry of Finance. And the greatest winner? Thanks to the long recession, the BoJ could push through legislation that made it independent and practically unaccountable for its actions - a goal it had striven for in vain throughout the post-war era. Unfortunately, the signs are that the BoJ is not making the best use of its independence. Starting to talk straight about its quantitative policies would be a nice beginning.

Richard Werner is Chief Economist for Tokyo-based Profit Research Center Ltd.