The Asian Wall Street Journal, Tuesday, June 13, 1995

Bank of Japan: Start the Presses!

By Richard A. Werner

Japan's longest post-war recession is now entering its fifth year. Nominal output is likely to fall dramatically this quarter, representing the first big decline since the 1930s. Real GDP won't look as bad, but only because prices are likely to fall more than 1%. With the yen having jumped by almost 20% against the dollar this year, deflationary pressures are accelerating. Unemployment is still rising, and Japan's social stability is beginning to show cracks.

What lies behind the biggest mess Japan has got into for half a century? In a recent article on this page ["Bank of Japan Can't Push on a String", May 29], Kengo Inoue, a senior official at the Bank of Japan argues that, "monetary policy is not the villain".

This seems hard to swallow. The very factor that has driven both the 'bubble economy' of the 1980s and the current depression in Japan has been nothing other than monetary policy. Being the source of the problem, it is also the only solution: no recovery in Japan is going to occur before monetary policy eases significantly. Indeed, improvements in capital flows and exchange rates (as well as most other variables) crucially hinge on monetary policy. If ever there has been an obvious villain, it is money, and the institution responsible for money in Japan is the Bank of Japan.

The real question is not whether the Bank of Japan can 'push on a string'. In essence, that means trying to get the economy going by lowering interest rates. But as Keynes pointed out when he coined the string metaphor in the 1930s, in a deflationary environment when real interest rates are approaching zero, that conventional view of monetary policy is powerless. Indeed, the BoJ has been pushing unsuccessfully on a string for several years: The official discount rate hit a historic low of 1% in April. Yet there are no signs of the economy getting off its back.

The problem is not the price of money (i.e. interest rates are too high). The problem is the quantity of money. The amount of purchasing power in the economy is shrinking, and only an increase can get the economy started again.

Any successful policy must involve the creation of extra money. Fiscal stimulus can be helpful, but only to the extent that that it is monetized (i.e. increases the amount of money in the economy). That has not been the case with Japan's four stimulus packages, which appeared to 'pump' 45 trillion yen (almost 10% of Japan's GDP) into the economy. Because they were not sufficiently monetized, their effect was merely to crowd out private-sector purchasing power.

History amply illustrates the importance of this lesson. In the 1930s, Roosevelt's New Deal began to help the U.S. economy only when the Fed finally printed money at a time of depressed output and a shrinking money supply. Hitler's vastly successful program of increased government spending only worked because he printed money. In pre-war Japan, Finance Minister Takahashi's policies helped to boost growth long before Keynes had even figured out what the problem was. In all these cases, the real solution was the aggressive expansion of the quantity of money.

The Federal Reserve has learned from history, and so should its counterpart in Tokyo. In 1990, the Fed faced a situation similar to the one prevailing in Japan today: U.S. banks had overextended themselves by aggressive real estate lending, which had driven up asset prices. When the bubble burst, asset prices collapsed and the real estate loans turned into bad debt.

This increased the risk aversion of banks, which responded by reducing loan growth. The economy moved into a deep recession. At that point the Fed did exactly the right thing: It printed money aggressively. This was undertaken largely through open market operations that injected liquidity directly into the system, without the need to use banks as intermediaries.

As a result, the economy recovered more quickly than many observers had expected. All the Bank of Japan needs to do now is copy what the Fed did five years ago.

Yet the BoJ sometimes argues that even if it wanted to increase the quantity of money (instead of just lowering interest rates) it could not do so: You cannot increase liquidity injections into the short-term money markets if there is no demand for the money. This is true, but beside the point.

Liquidity injections by the central bank can demonstrably go through avenues other than the money market and the banking system: The Bank can simply print money and buy government bonds. Without fail, this would increase purchasing power in the economy. The Bank of Japan also has the attractive option of massively buying U.S. dollars with newly printed yen. Indeed, a change of BoJ policy from yen destruction into more aggressive yen creation would send the yen into a dive.

There is virtually no limit to how much money a central bank can inject into the economy this way. This is often a problem. But in Japan's case today, running the presses would mean a lessening of deflation, a desirable outcome.

The power to create money is an awesome responsibility. No central bank likes to advertise that it can at will increase the quantity of purchasing power circulating in the economy. For one thing, admitting as much would invite much closer scrutiny by the public. That would in turn make it harder for central bankers to follow their own policy agendas (such as engineering structural change by prolonging a recession).

The second reason is more pragmatic: Central banks have to maintain an aura of conservatism. They hate phrases like 'printing money'. This, they fear would immediately reduce their credibility and open them to demands from various lobbies to 'print money' at times when it was economically unwarranted.

Normally central bankers are right to be cautious. But normally, they aren't facing an economy like Japan' s today. A bit of inflation and a slide in the currency sound like exactly the right medicine for a country where deflation is raging and the external value of the currency has surged to post-war highs that would have been hardly credible a few month ago.

So while there is no need to advertise what it's doing, the Japanese central bank now has not only a license to print money - it has a national duty to do so.

Richard Werner is Tokyo-based Chief Economist for Jardine Fleming Securities (Asia) Ltd.