

Bernanke's speech shows where BOJ failed

by Richard A Werner

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US Federal Reserve Board Chairman Ben Bernanke gave an interesting speech at the London School of Economics in mid-January. Unusual for speeches by the head of a major central bank, Bernanke was fairly direct in his message and coherent in his analysis. He also gave some insights into what seems to be his actual thinking. If he does mean what he said, then this speech could be of significance for the world economy - and also of interest in Japan.

The Bank of Japan has for almost twenty years insisted that it did not have the tools to end the banking-bust depression, could not help the deflation, was basically powerless, and that it depended on some structural reform that was supposed to be implemented by others - the government in particular. By contrast, Bernanke emphasized that the Fed had the tools available to battle the financial and economic crisis, and was using them without delay.

Bernanke has written about Japanese deflation and the policies of the Bank of Japan in his academic writings and has sharply criticized the Bank of Japan for its inaction and for allowing a banking crisis to be transformed into a multiyear economic downturn and depression.

Bernanke explained what he had written in his analysis of the Bank of Japan's policy many years ago in his lecture, namely that a central bank could eventually boost asset prices by creating money and putting it into circulation through purchases of assets and direct lending, and could in this way support and stimulate the economy. He used the term quantitative easing, which had become well known in the context of the Bank of Japan. Indeed, it is a term that was originally used in Japanese (*ryoteki kanwa*) in the early 1990s by critics of the Bank of Japan.

I have been one of the main users of this term because I wanted to contrast such needed policy from traditional ways of monetary stimulation or the monetarist way of referring to boosting the money supply. I wanted to emphasize that using the price mechanism of interest rates was not likely to help and therefore quantitative monetary policy of a different kind was required.

What's wrong with the BOJ?

While the expression quantitative easing had been mainly used by Bank of Japan critics, this changed in 2001 when the Bank of Japan proclaimed it would try what critics had then been demanding for almost a decade - one can't fault the bank for rushing into new things ... Thus in March 2001, the Bank of Japan announced it was officially going to change its monetary policy by switching from its alleged use of interest rates to adopting quantitative easing (later using the term *ryoteki kanwa* and translating this as quantitative easing in its English announcements).

However, the Bank of Japan's use of this term created much confusion because the policy it adopted in 2001 and many subsequent years was not the true quantitative easing that I had demanded. The quantity that needs easing is the quantity of credit creation. This is necessary and sufficient for a recovery in a situation like this. The Bank of Japan, however, chose to merely increase the reserves of banks held at the central bank. This is a traditional monetarist policy prescription, which boosts a measure called high powered money, but the measure is pointless. I had warned many times that this was likely to fail.

What good does it do the economy if banks deposit more money in the central bank? More credit creation is needed. That can only come from the central bank or through the normal route - from commercial banks through the extension of bank loans. But the Bank of Japan failed to boost credit creation. Thus its quantitative easing policy failed. As a result of this failure, the Bank of Japan's leaders would in the following years give speeches stating that the critics had been proven wrong. They would claim they tried quantitative easing as critics recommended, and it failed!

However, we witnessed only the *tatemae* (facade) of quantitative easing, not the *honno* (actual fact). Before 2001, the Bank of Japan did not actually want to reflate the economy. As Bank of Japan leaders have said on the record, they were quite happy about the recession because they used it to put pressure on the government to change laws and introduce US-style deregulated free-market capitalism.

Despite its official conversion to quantitative easing in 2001, this stance did not change. The central bank kept the quantity of credit creation tight. Thus, despite the nominal rise in high-powered money, the economy remained mired in recession. There was a brief recovery in 2006 - and again this is a case in point - it was based on a temporary recovery in credit creation. However, this policy was reversed by the Bank of Japan as soon the first shoots of recovery had become visible and Japan has been heading back into deflation ever since. One can only hope that the Bank of Japan will follow former Fed Chairman Alan Greenspan's recent example and admit that the current global crisis has disproved and discredited the deregulated free-market model.

Monetize fiscal policy

What is interesting about the Fed's current policies is that there seems to be some real - in the correct meaning of the term - quantitative easing going on. Credit creation by the Fed is ballooning. This is done by direct purchases of assets by the Fed and by direct lending by the Fed. The Fed has now also started to purchase mortgage-backed securities. It seems that Bernanke is not using smoke and mirrors. What he says seems to be what he actually thinks and plans to do (his *honno*) - quite a revolutionary approach to central banking.

Many observers and experts are currently wondering whether the world is now going to go down the road that Japan has traveled over the past eighteen years - a road that includes rising unemployment, deflation, falling asset prices and a shrinking economy. The potential for this to occur exists because the credit bubbles in Britain, Ireland, Spain, the United States and a number of other countries operated on the same mechanics as the Japanese bubble economy of the 1980s. Excessive credit creation used for speculative purposes drove up asset prices, but it was predictable that it all

had to turn into bad debts, busting the banking system and resulting in a credit-crunch recession.

The policy response taken by the key central bank may be where the parallels end. The current measures taken by the Fed and their scale are unusually aggressive and contrast sharply with the policies adopted by the Bank of Japan since 1991. The Fed also is monetizing fiscal policy, while the Japanese central bank has so far refused to do so. Thus at present, one can say that the US economy is likely to recover far more quickly than the economies of other countries, notably Japan. Where central banks continue to let credit creation stagnate, and where they refuse to monetize fiscal policy, economies will continue to shrink. At the moment, this includes Japan and Britain.

The British government's fiscal stimulation has been entirely unfunded, which means that all the government bonds issued to fund it have deprived the banking system of liquidity. Hence bank lending will continue to slow. For Britain and other post-bubble economies such as Ireland and Spain, we must expect a long slump, perhaps even on a Japanese scale. But that depends on the goals of the respective central banks.

One lesson we should learn is that there should be more public debate about the role of central banks in creating the current global crisis and the role they should play from now on. Over the past thirty years, central banks worldwide have become more independent from governments and parliaments. Yet, despite their increased power, macroeconomic performance has deteriorated and the world has seen an unusually large number of banking and economic crises.

In almost all cases, the crises were due to bubbles caused by excessive credit creation for speculative purposes - something I had warned needed monitoring and restricting by central banks. But the central banks chose to let credit creation rip. Only if the goal of central banks had been to create and exacerbate business cycles could we say that they have done a good job.

It seems clear, therefore, that the topic of central bank independence should be reviewed, for this independence has not had the desired results.

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