Response: What More Can the Bank of Japan Do?

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It is a pleasure to have the opportunity to respond to Dr. Okina's defense of the Bank of Japan's policy. I believe he has made as good a case as we are likely to see. I want to begin by agreeing with two important points that he makes.

First, Japan is not in a "great depression" nor has it experienced a rise in unemployment or decline in income, prices and money comparable to U.S. experience in 1929-33 or, for that matter Japan's experience at that time. Declines in stock prices, land and housing prices have drastically reduced household wealth in Japan, and commercial banks' loan losses exceed losses in the United States during the great depression, but the similarity ends there.

Second, we agree that Japan is not in a "liquidity trap" where monetary policy is powerless to affect prices, output, or other key variables. Wages and product prices have fallen. Land and housing prices continue to decline, and the yen-dollar exchange has appreciated from 145 in June 1998 to about 104 as I write. None of this experience seems consistent with a liquidity trap. A more likely explanation is that the fall in prices and the appreciation of the yen reflect an excess demand for money.

Dr. Okina, and many others, describes monetary policy as easy or accommodative. I do not agree. Falling prices and appreciating currency suggest that wealth-owners (at home and abroad) want to hold more Japanese money balances than the Bank of Japan has provided. The public can not create more yen balances, but they can increase the real value of their yen balances by demanding
yen. Their demands force the price level down and appreciate the yen-dollar exchange rate.

If the Bank of Japan increased the growth rate of money, it would help to achieve four important goals: (1) stop current and expected future deflation of wages and prices; (2) convert an excess demand for money into an excess supply, encouraging spending; (3) stop the fall in housing and land prices, thereby strengthening the financial system and ending the erosion of real wealth; and (4) depreciate the exchange rate, improving the competitive position of Japanese producers in world markets. The first three goals are not controversial, though there are differences about the means of achieving them. The fourth goal has been controversial, so I will discuss that.

The argument is often made that devaluation of the yen is harmful to Japan's neighbors and trading partners. Japan, it is said, should not recover at others' expense. Such statements are based on a misunderstanding. The real exchange rate—the quoted exchange rate adjusted for differences in prices at home and abroad—must change to restore Japan's competitive position in the world economy. The only issue is not whether the real exchange rate changes, but how.

There are three possibilities. First, Japan can use expansive monetary policy to devalue its quoted (or market) exchange rate. Second, it has been doing the opposite recently, so it must in the future let prices and wages fall enough to restore equilibrium. Third, it can hope that the U.S., Europe, and others inflate enough to ease the Japanese adjustment. Or, it can rely on a mixture of price and exchange rate changes.

Putting aside hopes that principal foreign countries inflate, wage and price deflation is the alternative to devaluation. There are no others. Those who oppose devaluation as too costly for Japan's neighbors and trading partners should recognize that Japanese deflation is expensive also, for its trading partners, its
neighbors, and its citizens. In my view--supported by the experience of the past
decade--devaluation would be a cheaper, and I believe, faster way to restore
prosperity to Japan and its neighbors.

The Japanese workforce is talented and productive. Japanese producers in
many industries have been creative and strong competitors. That's why Japan has
become the world's second largest economy. Although there are the much
discussed structural problems, there is a competitive core that would take
advantage of the yen's devaluation to produce more. As Japan returned to high
employment and growth, imports from neighbors and trading partners would
increase. The yen would appreciate. Japan's growth would help to restore Asian
prosperity and contribute to growth of the world economy.

Dr. Okina compares buying log-term bonds to buying dollars as a means of
expanding money. Either or both would work. Indeed, both would work about the
same way, and it would not be possible for an outsider to know which policy was
followed unless he or she looked at the Bank's balance sheet to see what the Bank
bought.

Almost two years ago, I urged the Bank to take five actions: (1) increase the
monetary base by purchasing any asset (other than Treasury bills that have zero
yield; (2) announce that the policy of buying assets would continue as long as the
threat of deflation remains or is expected to return; (3) announce that the private
sector has responsibility for ending the decline in asset prices, but the Bank's
policy will support their efforts by ending deflation and stimulating spending; (4)
accept that the government (or its agents) must absorb many of the financial
system's losses; and (5) allow the exchange rate to depreciate (temporarily) as
required by the expansive monetary policy.
The position of the banking system has improved, and the economy has stopped declining. If the Bank would take the other proposed actions, Japan would return to non-inflationary economic growth sooner.

Finally, permit me to comment on the safety or solvency of the Bank of Japan. I do not believe that the purchase of long-term bonds would jeopardize the reputation or safety of the Bank. There is little reason to believe that restoration of non-inflationary growth would raise interest rates enough to impair the Bank's solvency. Further many privately owned banks and financial institutions in Japan, the United States, and elsewhere have operated for long periods with impaired balance sheets. Both the Japanese and U.S. governments have current and prospective future liabilities far in excess of their assets. Yet, the public regards U.S. or Japanese government securities as two of the safest assets in the world. I see no reason to believe there would be any doubt about the government's obligation to stand behind the Bank.

The Bank should put its fears and concerns aside. Monetary expansion to and deflation is desirable for Japan, Asia, and the rest of the world. It is a mistake, to let concerns about short-term costs, such as temporary currency depreciation, delay longer-term benefits by continuing the deflationary policy of recent years. And this is especially true since the costs are less than the costs of continued recession and deflation.