



Japan Gingerly Exits Deflation

By John H. Makin

In August 2000, with the Japanese growth rate holding above 2 percent, the Bank of Japan decided to initiate an end to the zero interest rate policy that it had initiated in March 1999. This step was taken despite the existence of modest deflation, indicated by readings of minus 0.2 to minus 0.5 percent on various measures of inflation. At that time, no central bank had thought seriously about deflation as a threat since the depression of the 1930s.

The signal from the Bank of Japan (BoJ) that it was exiting the very accommodative monetary stance implied by setting its policy interest rate at zero tipped the economy into a dangerous slowdown. Deflation sharply intensified to minus 1 percent by early 2001. Growth slowed abruptly during the first half of 2001 to negative 4 percent. As the Japanese economy slipped toward an ominous deflationary spiral, the BoJ faced the ultimate central bank nightmare: a slowing economy with intensifying deflation and the target policy interest rate at zero—its maximum stimulative setting. To make matters even worse, the United States entered a recession during March 2001.

Deflation Is Dangerous

The nightmare of a deflationary spiral arises from the fact that as deflation intensifies and prices fall more rapidly, the real cost of borrowing rises. With a zero interest rate and 1 percent deflation, the real cost of borrowing is 1 percent. If deflation intensifies to 2 percent, the real cost of borrowing rises to 2 percent, while the demand to hold cash

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strengthens because the rise in deflation represents a rising, risk-free, tax-free return on cash. The move into cash further depresses spending and thereby further intensifies deflation. The real cost of borrowing keeps rising, imparting an accelerating drag on the economy.

Faced with this nightmare, the Bank of Japan elected to initiate a policy that has come to be known as *quantitative easing*. The BoJ decided to purchase assets directly from the banking system in order to increase cash held by the nation's private banks and by households. With deflation intensifying and a liquidity trap—an insatiable demand for cash—emerging, the Bank of Japan elected to satisfy that demand by simply printing money. Over a period of two and a half years starting in March 2001, the Bank of Japan boosted bank reserves from the usual level of about ¥5 trillion, equal to required reserves, to just over ¥32 trillion, or by ¥26 trillion (about \$240 billion). That is an extraordinary sum, equal to about 5 percent of Japanese GDP—the equivalent of \$600 billion in the United States or nearly one-half the U.S. M1 money supply (currency and demand deposits). The monetary base, the sum of bank reserves and cash held by households, rose by about ¥90 trillion (\$820 billion) as the flood of liquidity engineered by the Bank of Japan's purchase of assets from commercial banks accommodated a huge, growing demand for liquidity in deflationary Japan. The fact that deflation only gradually stabilized, given such a cascade of liquidity, is testimony to the seriousness of the deflationary threat Japan faced.

Fortunately for Japan, not to mention for the global economy, and much to the credit of the

Bank of Japan, the quantitative easing measures arrested deflation. The signal from the Bank of Japan that it was willing to print money in order to battle deflation stopped, but at first it did not reverse Japan's spiral. Nominal GDP—the sum of deflation and growth—stabilized in 2002 and began to rise modestly during 2003. Japan's core deflation rate still showed prices falling at about a 1 percent annual rate during most of 2002, but then it began to rise steadily toward zero during 2003. Deflation reappeared during 2004, but strong real growth kept year-over-year nominal GDP growth positive for most of the year. By mid-2005, year-over-year nominal GDP growth was 3.5 percent, signaling a combination of firm real growth and modest core deflation.

Japan in Recovery

There is little doubt that the Japanese economy, especially during 2005, has responded positively to the Bank of Japan's aggressive policy of quantitative easing. Along with positive growth and two months of positive readings on the year-over-year core consumer price index (CPI), have come classic signs of easier liquidity. Japan's stock market rose by 40 percent during 2005—far outperforming stock markets in other leading industrial countries. At the same time, the yen depreciated, another sign of ample liquidity.

Depreciation of the yen, which was associated with a return of more confidence to Japanese households, sent a mixed message to Japan's policymakers. As less intense deflation led Japan's households to seek alternatives to cash, they moved aggressively to purchase foreign government bonds, largely those issued by the United States, Australia, New Zealand, and Canada. Yet the Japanese avoided their own stock market. One of the ironies of 2005 is that, while the foreign demand for Japanese equities was rising rapidly as the economy recovered, Japanese households were choosing instead to invest in foreign government securities. They did so despite the exchange-rate risk that would impose losses were the yen to appreciate against foreign currencies. The easy liquidity conditions in Japan supported Japanese purchase of foreign bonds and foreign (U.S. and European) purchases of Japanese stocks. Apparently, Japanese investors have not recovered from the 1990 stock market collapse quite as fully as American

investors have recovered from the March 2000 NASDAQ collapse. Still, as we move into 2006, there are some tentative signs that Japanese investors are beginning to buy into the Japanese stock market, an encouraging signal of increased confidence in the sustainability of Japan's economic recovery.

Exiting Quantitative Easing

The recovery of Japan's economy and the easing of deflationary pressures have confronted the Bank of Japan with the difficult task of withdrawing the extraordinary stimulus that it has applied over the past five years to stabilize

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and then reverse a deflationary spiral. As noted, a deflationary spiral produces a sharp increase in the demand for liquidity that, if not satisfied by the central bank, will be satisfied by households and businesses by selling goods and services, thereby intensifying the deflationary spiral. With the intensifying deflation now arrested, the huge reservoir of liquidity residing in Japan's banks and in the hands of Japanese households has the potential to produce asset bubbles in the markets for stocks, bonds, and real estate as well as sharply higher prices for goods and services if it is rapidly spent. Some have argued that the huge stock of liquidity in Japan has already contributed to higher bond prices and correspondingly lower interest rates in countries like the United

States, Australia, and New Zealand, where Japanese investors have gone to earn higher returns on "safe" government bonds.

Simultaneously, foreign investors who have been aggressive purchasers of Japanese stocks have found very inexpensive financing, thanks to the Bank of Japan's zero interest rate policy, along with a generous liquidity provision that makes Japanese banks a generous supplier of credit for leveraged purchases of Japanese assets by foreign buyers.

The real question facing the Bank of Japan is whether the current recovery of Japan's economy and asset markets still requires the generous provision of liquidity that has occurred through Japan's quantitative easing strategy. Beyond that lies the question of what will happen to Japan's asset markets and economy if the zero interest rate policy is ended. The BoJ has begun to confront these

questions, suggesting that it will begin to reverse its quantitative easing policy sometime later this spring—probably in April. That would involve withdrawing about ¥26 trillion from the banking system, a huge sum as already noted, the equivalent of one-fifth of the monetary base (the sum of household cash and bank reserves).

Just as quantitative easing was an unprecedented experiment for the Bank of Japan, which fortunately succeeded, the removal of that quantitative easing necessarily constitutes another move into uncharted territory. Success is not guaranteed. Quantitative easing, though it did not lead to much more lending by Japan's banks, amounted to a signal from the Bank of Japan that it was prepared to maintain an extraordinarily accommodative liquidity policy until it judged the Japanese economy to be on the path to a sustainable recovery. That policy signaled to investors wishing to finance purchases of bonds, stocks, land, or other assets that financing would be available at very low (zero) short-term rates for an indefinite period of time. Now that the Bank of Japan has clearly signaled its intention to remove the liquidity accommodation implicit in quantitative easing and subsequently to begin modestly to raise interest rates, perhaps by 15 or 20 basis points as it did in August 2000, the guarantee of an indefinite stream of easy financing at virtually zero interest rates is being withdrawn.

The Bank of Japan's reasoning behind this step, given its judgment of the outlook for the economy, is sound enough. In a normal economy, with stable prices growing at about 2.5 percent, it is inappropriate to have zero policy interest rates and a far larger quantity of reserves on hand in the banking system than is normal. Such a stance could lead to a rapid run-up in asset prices and inflation that ultimately would be self-defeating. So, the Bank of Japan has elected to signal to investors that its period of extra accommodation is coming to an end. That is the bad news. The good news is that the transition to a more normal monetary policy is contingent upon the appearance of a more normal economy, with steady growth and modest positive inflation.

Normalization Risks

The Japanese government, not to mention investors and consumers in Japan, are understandably nervous about the central bank's necessary but momentous step toward normalization of monetary policy within the context of normalization of the Japanese economy. Japan's economy has not really been normal for a decade and a half, since

the collapse of the stock and land markets in the early 1990s. Sensitivities about premature tightening by the Bank of Japan were, of course, heightened by the disastrous results that followed from its last effort, in August 2000, to exit a zero interest rate policy. A mistake at this stage could risk a resumption of deflation and a jump in real interest rates—consequences that debilitated the economy and Japan's asset markets during 2001.

The Bank of Japan probably has little choice but to move toward normalization of monetary policy as economic performance in Japan improves. The proximate risks probably lie in the Japanese bond market, where outstanding debt, heavily owned by Japan's banks and households, totals over 140 percent of GDP. Yields on ten-year Japanese government bonds have ranged between 1.4 and 1.6 percent over much of the last year. As the Bank of Japan exits its quantitative easing stance, it will, by necessity, reduce its holdings of Japanese government securities, thereby requiring more purchase by the private sector. Higher interest rates will be required to attract private-sector buyers of government bonds in a growing global economy in which many attractive alternative investments are available. The quantity of government securities that the private sector will need to absorb will rise as the return of modest inflation and stable growth boost interest rates. Given the continued large budget deficits of the Japanese government, higher borrowing costs are somewhat problematic but are manageable in the context of a firmly growing economy that will generate higher revenues.

Looking further ahead to the end of this year, the Bank of Japan is understandably anxious to regain discretionary control over monetary policy. The quantitative easing strategy was an extraordinary step, which in the context of zero interest rates left the BoJ with little ability to conduct normal day-to-day operations in the financial markets. In a sense, a return to positive short-term policy interest rates, however modest, restores to the BoJ its accustomed interest-rate instrument and, of course, symbolizes a return to normalcy for the Japanese economy. The tricky part of this operation lies in being sure that the desire for the trappings of normalcy—no extraordinary quantitative easing stance and a positive policy interest rate—does not overwhelm the need to maintain such measures in order to ensure a sustainable recovery.

The Japanese are using an illuminating analogy with human behavior to describe the process of normalization. They liken the Japanese economy to a patient who has long been bedridden and in need of intensive care. The

time has come, in the view of many, now that test results show significant improvement, to allow the patient to get up and move about on his own. This is all well and good provided that the patient does not experience a relapse.

Two other risks are associated with normalization of Japan's monetary policy. The first is inside Japan, and involves fiscal policy. The second is outside Japan, and is tied to the stance of monetary policy in the United States.

Over the coming year, the policy-induced fiscal drag scheduled for Japan will be equivalent to about 0.6 percent of GDP. This is far smaller than the disastrous fiscal policy tightening implemented in 1997, which included a hike in the consumption tax and amounted to almost 2 percent of GDP. However, the withdrawal of any stimulus from the Japanese economy does assume that "the patient" is truly well and able to be up and about even in the face of some additional drag from fiscal policy. Beyond the fiscal drag that is already scheduled lies the promise of further consumption tax increases for the 2007 fiscal year. This is troubling because consumption has, so far, been the laggard part of the current economic recovery. Discussion of higher taxes will intensify this fall during the planning period for the budget and after the expected departure of Prime Minister Junichiro Koizumi, who has been clear about his desire to delay any additional fiscal tightening until the Japanese economy is fully on the road to recovery.

The other risk to the Japanese and to the global economy may lie in the United States. As we enter 2006, there appear to be few signs of an effectively restrictive monetary policy in the United States. The economy is re-accelerating to what will probably be a growth rate of above 5 percent during the first quarter and perhaps 3.5 percent during the second quarter. Although the Federal Reserve has undertaken its own policy of normalization, raising the federal funds rate from 1 percent in June of 2004 to 4.5 percent in January 2006, the American "patient" is long out of bed and eager for more spending action.

If we reach May or June of this year with an unemployment rate even below the low 4.7 percent rate reported in January and core inflation rates creeping toward 2.5 percent, the Federal Reserve will have little choice but to contemplate interest-rate increases beyond the 4.75 to 5 percent ceiling currently envisioned by markets. This "surprise" additional tightening, if it is taken in conjunction with removal of quantitative easing in Japan, will signal a marked reduction in monetary accommodation coming simultaneously from the central banks in charge of world's two largest economies. One hopes that the Bank of Japan and the Federal Reserve

will continue to maintain close communication on the paths of their policies as 2006 unfolds.

Good Luck, BoJ

There is no doubt that the Bank of Japan has conducted a remarkably successful monetary policy under extraordinarily difficult circumstances over the past five years. The decision to initiate quantitative easing in March 2001 marked the beginning of an experiment the likes of which have not been seen in the history of monetary policy. (The Federal Reserve contracted liquidity in the deflation that accompanied the Great Depression after 1929, with disastrous results.)

As the move to end quantitative easing and return to positive interest rates unfolds in Japan, the Bank of Japan is undertaking to keep markets fully informed of its intentions in order to avoid any unwelcome surprises. Any investor, household, or business in Japan today that is not aware that an end to extraordinary accommodative liquidity conditions is going to occur over the balance of 2006 is severely out of touch both with reality and the financial news media.

Although the Bank of Japan has made no secret of its plan to exit quantitative easing, it has thus far offered little clear guidance either on when it will initiate an end to that policy or how long it will take to remove the huge cache of liquidity, equal to 5 percent of GDP, from the monetary base. Additionally, the BoJ has not offered any public guidance on the probable timing of increases in its policy interest rate. Rather, a stream of hints from its policy board members, together with reactive comments from Koizumi government spokesmen, has provided fuel for a steady stream of market disruptions.

The Bank of Japan needs to maintain some flexibility in the pace at which it moves and to delay initiation until it is confident that deflation is truly dead. It has said as much. If that is true, less talk from both its policy board and from the government is in order until the BoJ is ready to articulate the outlines of its path to normalization of its policy stance.

If the Bank of Japan successfully exits quantitative easing and normalizes monetary policy with a return to modest positive interest rates, it will have—as already noted—successfully completed one of the most important experiments in the history of monetary policy. Central bankers the world over, not to mention policymakers and financial market participants, wish them well. We all have a great deal riding on a successful outcome.