

TIME FOR JAPAN TO INFLATE

By

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March 1999

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Over the past few weeks, Japan's central bank has moved to ease monetary policy by lowering overnight bank-lending rates to zero. This shift by the Bank of Japan is a welcome sign that, at long last, both fiscal and monetary policy levers in Japan are set on expansion. With a serious bank-restructuring plan now in place and significant fiscal stimulus in the pipeline, a monetary expansion is the third leg of a balanced approach for returning Japan to economic health. But the Bank of Japan must be prepared to stay the course and loosen policy further in coming months.

The shift toward easier monetary policy has contributed to a recent drop in long-term interest rates, which had risen late last year in anticipation of increased government borrowing to finance huge fiscal stimulus and bank restructuring programs. Rising rates had threatened to curtail an already restrained level of spending on investment and consumer goods—spending that needs boosting if Japan is to emerge from its decade of stagnation.

This turnaround in long-term rates alone, however, will not prove sufficient to spur spending. Rates are already quite low and have been for some time: the recent peak for the 10-year government bond rate was just below 2.5 percent and this rate has not exceeded 3 percent since mid-1996. And with domestic prices continuing to fall, inflation-adjusted interest rates remain above nominal rates, acting as a drag on private-sector spending. The Bank of Japan should halt this deflationary spiral by loosening monetary policy enough to induce price inflation and thereby push real interest rates below zero.

Japan has witnessed a period of sustained deflation not seen among major industrial countries since the 1930s. Domestic prices have declined by over 10 percent since 1991, and the pace has recently accelerated: the latest data from the Bank of Japan show domestic wholesale prices fell nearly 2.5 percent during the past year. The Japanese stock market remains far below its value of a decade ago and real estate prices continue to sag. Although low prices raise purchasing power and might be expected to spur spending, anticipation of even lower prices in the future has caused consumers and

businesses to postpone spending. And deflation in asset prices has led to deteriorating balance sheets among banks and businesses, restraining lending and investments.

With a package of fiscal stimulus and bank restructuring in place, monetary policymakers in Japan may be tempted to wait before easing further, arguing that effects from these other policies should be allowed to run their course before committing to additional monetary stimulus. But the time to expand upon the recent shift toward looser policy is now for several reasons.

First, the yen has strengthened considerably against the dollar and the Euro in since last summer, providing a cushion for the inevitable weakening of the currency as monetary policy is loosened. The yen is now roughly 20 percent above its dollar value of last August. This cushion helps limit import-price inflation since a decline now in the yen merely offsets its earlier rise.

Second, the gain in the yen since last summer also provides important breathing room for China to hold off devaluing the renimbi. China would be far more likely to devalue its currency to regain competitiveness against Japanese exporters if the yen had remained at its August low and additional decline was now expected.

Third, the burgeoning U.S. trade deficit and recent dumping disputes over steel and other products are likely to gain increased attention during next year's Presidential election, making a weakening yen easier for the Clinton Administration to accept this year than in the politically-charged atmosphere of next year.

Finally, the Japanese government has announced plans to issue 31 trillion yen in new bonds during the fiscal year starting April 1, which is certain to put upward pressure on interest rates in order to attract buyers for these bonds. By printing money to purchase government bonds, the Bank of Japan could support this influx of new government debt, and help ensure that the boost to demand from spending programs financed by this debt is not offset by higher interest rates. Although Japanese law prevents the Bank from directly purchasing debt issued by the government, open market operations in which the Bank purchases bonds in the secondary market would accomplish the same purpose.

By choosing to further ease monetary policy, the Bank of Japan will be taking advantage of an economic and political environment that provides a prime opportunity for Japan to finally emerge from its "lost decade." As Europe lurches toward recession and emerging economies continue to bear the fallout of financial market turmoil, restoring Japan as an engine of world growth is crucial. The Bank of Japan has taken important first steps to achieve this. Now it must follow through and complete the job of returning Japan to economic health.

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