Monetary Policy in the New Global Economy: The Case of Japan

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Globalization, Money, and Exchange Rates

The title of this paper suggests an old question in a new form: Have institutional changes, in this case so-called globalization, reduced the effect of money on prices and other nominal variables? The simple answer is no, but a more complete answer would be, no for large countries like the United States but perhaps yes for small, open economies with free capital movements. I will give two principal reasons.

First, globalization is a much overworked term. As Michael Bordo, Barry Eichengreen, and Kim Jongwoo (1998) have shown, the size of trade or capital movements relative to GDP (or other relevant bases) have returned to the neighborhood they were in a century ago. There are some differences. There are more and different types of financial instruments, more independent countries and, of course, a major change in the international monetary standard. Instead of the gold standard, we have a mixed system in which principal currencies float.

Second, the power and influence of a central bank—and the key fact that distinguishes a central bank from any other bank—is its control of its country's monetary base. The central bank is the only institution that can create base money. As long as there is a demand for base money, this is a valuable monopoly.

How could an economy's increased openness affect the value of this monopoly right? Increased openness (or globalization) is neither necessary nor sufficient to generate substitution of one currency for another. Substitution of foreign for domestic money as a means of payment, however, would reduce the value of the local monopoly.

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At one extreme, a properly functioning currency board would eliminate the power of the central bank to create money at its own discretion. Like any rigid fixed exchange rate system, a currency board makes the stock of domestic base money depend on capital flows. There is still a demand for domestic base money, so the central bank has as much of a role under a currency board as it has under the classical gold standard. Under the Bretton Woods system, many countries restricted capital flows. There was little globalization, but the influence of a central bank that followed the rules was not much different than under a currency board.

Some economists have concluded recently that with the increased size of capital movements, there are only two exchange rate systems that can be sustained in the long run. The claim is that choices are limited to completely fixed or freely floating exchange rates. Adjustable pegs, target zones, and other intermediate arrangements are ruled out. It seems useful to recall, therefore, that this is the same conclusion reached by Milton Friedman in his classic 1953 paper on exchange rate systems. That paper was written long before globalization became an issue. Time has not eroded the value of Friedman's contribution. However, with the passage of time, Friedman's conclusion has gained acceptance.

The Case of Japan

Let me turn to Japan's monetary policy. Many critics discuss Japan's economy as if Japan is reliving the Great Depression of the 1930s.

Japan is not in a "great depression." It has not experienced a rise in unemployment or a decline in income, prices, and money comparable to U.S. experience from 1929 to 1933 or, for that matter, Japan's experience at that time. Declines in stock prices, as well as in 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.

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 rate has appreciated. None of this experience is 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.

Many Japan-watchers describe 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 (BOJ) 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 United States, 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 work force is talented and productive. Japanese producers in many industries have been creative and strong competitors. That is why Japan has become the world's second largest economy. Although there are the much discussed structural problems, there is a sizeable 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.

Some economists urge the BOJ to buy long-term bonds, others to buy 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 BOJ's balance sheet to see what the bank bought.

I have urged the BOJ 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 those 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.

Conclusion

If the BOJ would take those proposed actions, Japan would return to noninflationary economic growth. I do not doubt that the officials of the bank share that objective. They are repeating a classic error—equating low interest rates on government securities with monetary ease and ignoring evidence of an excess demand for money.

References

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