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Money and Deflation in Japan

During the past 30 years, Japan has had more success than most countries in quelling inflation. In the 1990s, its comparatively low inflation environment has evolved into occasional deflation and an extended period of low real growth, which was negative in fourth quarter 1997 and first quarter 1998. Long-term interest rates have fallen to under 1.5 percent and short-term rates to 0.5 percent. Given Japan's very low nominal interest rates, could monetary policy do still more to counter sluggish demand and deflationary forces?

The chart plots growth in a broad monetary aggregate (M2+Certificates of Deposit), the GDP price deflator, and real GDP in Japan from 1970 to 1997. In the early 1970s, Japan's monetary growth accelerated when the U.S. dollar's link to gold was abandoned. Japan resisted an appreciation of its currency by allowing faster domestic monetary creation. What followed in the mid-1970s was a substantial inflation with sharp increases in oil and other primary product prices.

Later in the 1970s, Japan restored a low inflation environment. It experienced nothing like the double-digit inflation the United States saw in the late 1970s and early 1980s. Unlike the U.S. experience, Japan's monetary growth drifted down from levels of the early 1970s. Inflation in Japan also drifted down from a 1974 peak with only a modest relapse in 1980. There was a gradual upturn in monetary growth in the mid-1980s. What followed in the late 1980s was a gradual increase in inflation, although it remained low compared with the 1970s experience.

Entering the 1990s, with inflation about 2 percent, monetary growth fell sharply in 1991 and 1992. In part, this restrictive monetary impulse reflected actions by the Bank of Japan to slow rapid increases in asset prices in the so-called "Bubble Economy." What followed was that inflation in goods and services prices fell to about zero (with slight deflation in 1995 and 1996), and asset prices tumbled. Unexpected disinflation—as presumably has occurred in Japan in the 1990s—has had deleterious effects on both asset prices and the soundness of bank loans.

There may be other ways of restoring the Japanese economy, but the historical record that links inflation directly with monetary growth in Japan suggests that policy actions aimed at stimulating monetary growth would provide a bulwark against the problems associated with deflationary pressures and recession.

Whether the Bank of Japan could pursue a more expansionary monetary policy by buying securities to increase the supply of base money is sometimes questioned because interest rates are exceptionally low in Japan. Sufficient monetary expansion, however, would meet the liquidity demands in the economy and, thereby, aid the recovery even if interest rates remain low. A central bank *in a deflationary situation with troubled banks* must avoid interpreting low interest rates as an indicator of an expansionary policy. When monetary growth is low and default risks are high as in Japan today, low interest rates reflect expectations of both low (or negative) inflation and rates of return. In such a situation, *the appropriate focus of monetary policy is on money and not interest rates.*

–William G. Dewald

Monetary Growth and Inflation in Japan