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Reinventing Central Banking

In some ways, economics, particularly economic policy making, has much in common with medicine. This is particularly true when it comes to the art of central banking. Since one of the oldest rules in medicine is for the physician to "do no harm," one ought not to be surprised that this is also a suitable maxim for the economic policy maker. "Doing no harm" must also include, failing to take necessary actions because those actions are not sufficient to cure all of the illness from which the patient suffers. Since nearly all economic maladies including secondary and tertiary complications, can cause the policy maker to be diverted from doing what he can, it is important that he recognizes when his actual tools will not be sufficient for all of the symptoms. The true art of economic policy is to set the priorities or the sequence of proper economic policy remedies. It is nearly identical to the treatment dilemma faced by a physician in an emergency circumstance. The wise physician will recognize that the patient is suffering from a series of ailments and to regain full health, each of these conditions needs to be addressed. However, it is the art of the great physician to recognize the essential priorities, to first combat the threats to life itself, as the physician organizes the appropriate medical response. And so it is with the application of economic policy when confronted with a serious, and indeed life-threatening economic disorder. Do the right thing and do it first. Allow the other symptoms to be treated each in their proper sequence. Above all, do no harm!

For some reason, the fundamental wisdom that the sequence of policy actions is as important for regaining economic health as is a full understanding of all of the ailments that confront an economy, is in danger of being lost as we watch both the U.S. and Japan restore some of their former economic vitality. Having finally understood the central role of the Central Bank in fighting deflation, it is important that policy evaluation in the post deflation period into which Japan is now passing, not fall victim to a confusion of primary and secondary causality.

In my view, the major inference to be drawn from the Japanese experience of the 1990's is that the Bust was going to do significant harm to the financial wealth of Japan, which in turn would create significant behavioral obstacles to restarting the economy. The Bank of Japan had the power to mitigate much of the damage of the bust, particularly the damage that the economy was suffering through the strong deflationary bout that followed the bursting of the bubble. Instead, however, even after the BoJ secured its independence and had the power to 'do the right thing,' it became unnecessarily tangled in the complexity of economic events. By so doing, it found even further reason to delay the administration of the proper remedy and that delay significantly contributed to the economic malaise that followed. It became increasingly difficult to re-start the Japanese growth engine. As a result, many policy critiques focused on why the Bank was not sufficiently powerful to act and that "fundamental reform" was required for the economy to regain its health. What this analysis did, however, was to promote the delay in exercising suitable monetary expansion or to limit its extent on the grounds that it would be insufficient in the absence of fundamental reform.

Not surprisingly, the BoJ found in these collateral symptoms many excuses for its own failure. That was a tragedy that was neither necessary nor predictable because the basic remedy to asset deflation was thought to be part of the primary arsenal of monetary economics in the 1990's. One excuse often heard in response to the question, "why is the BoJ not doing more?" was the fear that excessive monetary expansion would create an inflation that would then be hard to control. What a convolution of responsibility since a healthy dose of inflation applied to an economy suffering real deflation is just "what the Doctor should have ordered!"

The BoJ's delay is even more incomprehensible when we realize that central conclusion that comes from the study of the previous "great failure to act" ---the Fed's monetary policies during the Great Depression---had already become a central tenet of monetary theory even prior to the Japanese Bubble and Bust. While it is

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certainly true that there was much to be corrected in the Japanese economy, following the Bubble and the Bust, the fundamental lesson about deflation (inflation) is that it is still largely and certainly primarily a “monetary phenomenon. How it was that the Bank of Japan failed to understand that lesson will be the central mystery to be unraveled by economic historians studying Japan’s economic history in the 1990’s and early 2000’s.

As the corrosive effects of deflation spread throughout the Japanese economy, all sorts of collateral symptoms appeared: massive bankruptcies, pullbacks in household consumption, the revelation of much “excess capacity,” and not surprisingly, a significant impairment to the traditional “channel” of monetary policy, the commercial banking system. That impairment affected how the BoJ would come to ‘do its duty,’ but it should never have been used as an excuse to delay proper monetary stimulus or to recognize that saving the patient was the first order of business. What was needed was economic triage, applied firmly and immediately.

In addition to failing to recognize the danger from an unstopped deflation, the BoJ failed at critical moments to distinguish between low nominal interest rates and tight monetary policy during a deflationary process. That is another mystery since that distinction is also integral to modern day monetary policy theory and taught to every student of monetary economics. It is hard to account for the Bank of Japan’s failure to mind a lesson so well understood by the beginning of the 1990’s. The lesson followed directly from the classic work in monetary history by Friedman and Schwartz and to this day remains largely uncontested. How that lesson got lost in Japanese policy circles, despite so much international commentary on Japanese policy making during the late 1990’s, must also be explained. Confusion between primary and secondary causes is evident in the Bank’s failure to recognize that the Japanese economy’s life-threatening ailment was deflation, and the impairment of the commercial banking system was a consequence not a cause. For far too long, the weakness of the commercial banking system became a reason not to act aggressively on the grounds that the central bank’s action would be frustrated by a collapsed commercial banking system. It took far too long for the BoJ to move to “extraordinary measures,” despite the constant urging of many economic policy analysts. The BoJ did recognize that the traditional ‘money multiplier’ had changed drastically, but that should have been a spur to use extraordinary measures rather than joining in the campaign for bank reform that while important was not essential to its purpose. That clamor, important in its own right, was a diversionary disturbance.

It now seems that much of the deflationary winds that have buffeted the Japanese economy in the early 2000’s are finally being successfully countered. In our view, the decisive change came first in March 2001 when the BoJ first addressed the issue of “zero interest rates” in conditions of deflation. By adopting a quantitative policy criterion, it freed itself from the self-imposed fallacy that it was being “easy” because the policy rate had fallen to zero! And it has continued to apply the proper monetary medicine, albeit tentatively in the view of many monetary economists. Recently, the MoF has become fascinated with the exchange rate and its intervention to prevent the yen from rising is providing additional “cover” for even more massive monetary stimulus.

There is and will be a considerable debate over monetary stimulus and sterilization, but it is evident that much of the depressing state of expectations that had nullified much of the monetary stimulus in earlier periods is coming to an end. As a result, Japan is beginning to regain some traction. As that traction is regained, a secondary effort to cure the secondary disease issues can be more successfully maintained. The lesson is clear: first prevent the patient from dying; second, then, and only then, address the secondary ailments.

Current post mortems of Japanese economic failure often fail to distinguish between primary and secondary causality. A recent critique of the “lessons of Japan,” that has motivated much of Fed behavior during our own (moderate) deflation suggests that the Fed has taken the wrong lesson from the Japanese experience. The Fed may be criticized for many things, but in our view, it got the lesson of the Japanese Bust largely correct.

The central lesson drawn by the Fed in its analysis of recent Japanese economic history was to recognize the perniciousness of deflation once started and the need to combat that economic malaise quickly and decisively. The Fed not only drew the right inference, but it geared its own policies on that basis. It clearly recognized that the health of the U.S. commercial banking system was extremely important in and of itself and because it preserved much of the efficacy of strong applications of traditional reserve creation powers by the Fed. The fallout of the BoJ's failure to act decisively at the proper moment was not lost on the Fed. Once the Fed realized the possible severity of a failure to act forcefully in the face of a bust, it became a proper deflation-fighting machine and it got reasonably efficient policy traction in 2001. And, so far, it has not yet relented.

More than anything else, the Fed's sticking to first causes has produced a major policy triumph by the Fed--- despite its early critics. Now, when deflation is vanishing as a threat, critics of Fed policy are beginning to say, "stop," you are creating a set of new bubbles. Victory has far too many fathers!

Strangely, there is now criticism from many who evidenced great suspicion over the efficacy of monetary measures in combating a bust, that the Fed is a "serial bubble blower." And perhaps it is not surprising that commentators on Japanese economics are confusing the 'sequencing' issue with the primacy of deflation as the central causative element in Japan's 'dismal decade.' It would be a tragedy if the central lesson is lost, once it has been finally understood by the BoJ, who proved for several years a rather inept student.

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