Rx for Japan: Back to the Future

By Milton Friedman

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A decade of inept monetary policy by the Bank of Japan deserves much of the blame for the current parlous state of the Japanese economy. That decade followed a period of excellent monetary policy. In 1973, the Bank of Japan reacted to an accelerating rise in inflation by bringing monetary growth down to nearly 10% a year from over 25% in the course of less than two years. It also announced an explicit policy of controlling monetary growth.

As the accompanying chart shows, after a lag of a year, nominal income decelerated sharply, and then after another year, so did inflation, from over 20% to single digits. Monetary growth continued to decline unevenly for nearly another decade, and then stabilized. Inflation followed suit, falling to less than 3% annually for years on end. After a brief recession in 1974, real growth resumed at a respectable and fairly steady rate, averaging nearly 4% per year from 1977 to 1987. Those were the golden years.

Then, at the Louvre conference in February 1987, the assembled leaders agreed to stabilize the foreign exchange value of the dollar. Japan, as its part of the deal, bought dollars, in the process creating yen. The resulting acceleration in monetary growth led to higher inflation and, initially, to higher real growth. The most notable result was the “bubble economy,” an explosion in the prices of land, stocks and other assets; the Nikkei stock index more than doubled in three years.

The Bank of Japan reacted belatedly in 1990, reducing monetary growth to less than 3% from 13% in the first year of the new policy, and to negative rates in the second--too much of a good thing. Tight money was spectacularly effective; the stock market, and also nominal income growth, plunged. Low inflation turned into actual deflation by 1994. Monetary growth has recovered since, but remains at the lowest level of the postwar period.

The accompanying table compares the past five years with a five-year period a decade earlier, during Japan’s golden years. Seemingly small numerical differences are enough to convert a healthy economy into a sick one.
The surest road to a healthy economic recovery is to increase the rate of monetary growth, to shift from tight money to easier money—to a rate of monetary growth closer to that which prevailed in the golden ’80s, but without again overdoing it. That would make much-needed financial and economic reforms far easier to achieve.

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<td>Money(a) 8.2% 2.1%</td>
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<td>Income(b) 5.0% 1.3%</td>
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<td>Prices(c) 1.7% 0.2%</td>
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<td>Output(d) 3.3% 1.0%</td>
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(a) M2+CDs for year earlier than indicated period.

(b) GDP in current prices.

(c) Implicit GDP deflator.

(d) GDP in constant prices.

Source: Haver Analytics

Defenders of the Bank of Japan will say, “How? The Bank has already cut its discount rate to 0.5%. What more can it do to increase the quantity of money?”

The answer is straightforward: The Bank of Japan can buy government bonds on the open market, paying for them with either currency or deposits at the Bank of Japan, what economists call high-powered money. Most of the proceeds will end up in commercial banks, adding to their reserves and enabling them to expand their liabilities by loans and open market purchases. But whether they do so or not, the money supply will increase.

There is no limit to the extent to which the Bank of Japan can increase the money supply if it wishes to do so. Higher monetary growth will have the same effect as always. After a year or so, the economy will expand more rapidly; output will grow; and after another delay, inflation will increase moderately. A return to the conditions of the late ’80s would rejuvenate Japan and help shore up the rest of Asia.

Initially, higher monetary growth would reduce short-term interest rates even further. However, as the economy revives, interest rates would start to rise. That is the standard pattern and explains why it is so misleading to judge monetary policy by interest rates. Low interest rates are generally a sign that money has been tight, as in Japan; high interest rates, that money has been easy.

Japan’s recent experience of three years of near zero economic growth is an eerie, if less dramatic, replay of the great contraction in the U.S. The Fed permitted the quantity of money to decline by one-third from 1929 to 1933, just as the Bank of Japan permitted monetary growth to be low or negative in recent years. The monetary collapse was far greater in the U.S. than in Japan, which is why the economic collapse was far more severe. The U.S. revived when monetary growth resumed, as Japan will.

The Fed pointed to low interest rates as evidence that it was following an easy money policy and never mentioned the quantity of money. The governor of the Bank of Japan, in a speech on June 27, referred to the “drastic monetary measures” that the bank took in 1995 as evidence of
"the easy stance of monetary policy." He too did not mention the quantity of money. Judged by the discount rate, which was reduced to 0.5% from 1.75%, the measures were drastic. Judged by monetary growth, they were too little too late, raising monetary growth from 1.5% per year in the prior 31/2 years to only 3.25% in the next 21/2.

After the U.S. experience during the Great Depression, and after inflation and rising interest rates in the ’70s and disinflation and falling interest rates in the ’80s, I thought the fallacy of identifying tight money with high interest rates and easy money with low interest rates was dead. Apparently, old fallacies never die.

Mr. Friedman, a winner of the Nobel Prize in economics, is a senior fellow at the Hoover Institution.

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