The Japanese Economy
SPRING 2003/VOL. 31, NO. 1

Deflation

Endgame or Sideshow for the Japanese Economy?

Editor's Introduction
WALTER F. HATCH 3

How to Beat Deflation
Take Action with Unconventional Monetary Policies
TAKATOSHI ITO 7

The Fate of Structural Reform
HIROSHI KATO 14

The Underlying Cause of Deflation
Structural Factors or Monetary Policy?
SEIJI SHINPO 26

Japan's Confidence Crisis
KEIICHIRO KOBAYASHI 59

Comment on Richard A. Werner's "The Enigma of Japanese Policy Ineffectiveness: The Limits of Traditional Approaches, Not Cyclical Policy"
WILLIAM W. GRIMES 69

Response to William W. Grimes, "Comment on Richard A. Werner's 'The Enigma of Japanese Policy Ineffectiveness: The Limits of Traditional Approaches, Not Cyclical Policy'"
RICHARD A. WERNER 82

With this issue, *The Japanese Economy* moves in a new direction. While maintaining the commitment to serious scholarship made by its previous editor, Professor Kazuo Sato, the new editor, Walter Hatch, hopes to bridge disciplinary divides. As the essays in this issue indicate, the journal will include political-economic analysis in addition to more technical and traditional economic analysis. Practical policy implications will be explored at every turn. The goal here is to create a dialogue among economists, political scientists, and intelligent lay people over the nature of the world's second-largest economy.

The Japanese Economy (ISSN 1097–203X) is published quarterly by M.E. Sharpe, Inc., 80 Business Park Drive, Armonk, NY 10504. Subscription rates (vol. 31) for U.S. institutions: one year, $823.00. For foreign institutions: one year, $925.00. Prices are subject to change without notice. Subscriptions are nonrefundable. Back issues of this journal, are available at the subscription price effective on the date of the order. Price information on bulk orders or back volumes of the journal (to Volume I, No. 1) is available upon request. For individual subscription rates and other inquiries, please call 1-800-541-6563 or fax 914-273-2106.

The Japanese Economy, vol. 31, no. 1, Spring 2003, pp. 3–6.

ISSN 1097–203X / 2004 $9.50 + 0.00.

WALTER F. HATCH

Editor's Introduction

In the 1970s and 1980s, policymakers in industrialized economies around the world fretted over inflation. Now they worry more about inflation's mirror image: deflation, a long-run, secular decline in an economy's overall price level as measured by the gross domestic product (GDP) deflator or the Consumer Price Index.

Germany has been experiencing deflationary pressures associated with a large output gap, high unemployment, and persistent weakness in the banking sector. So have Hong Kong and Taiwan. But no economy has felt these pressures more than Japan, which has been caught in a deflationary cycle since 1998 (if you use the Consumer Price Index as your measure) or perhaps even since 1995 (if you follow the GDP deflator). Expectations drive this cycle: falling prices lead to a widespread expectation of further declines, which accelerates the trend and heightens expectations even more. Surveys show that households and firms in Japan expect prices to keep falling in the foreseeable future. Should Japanese policymakers be alarmed? And what, if anything, should they do?

This issue of *The Japanese Economy* examines Japan's policy options in the face of deflation.

Before deciding how (or even whether) to combat deflation, policymakers must try to understand where it came from in the first place. Deflation is usually driven by a negative demand shock or a positive supply shock, or a combination of the two. The former may reflect a cyclical downturn in the economy, the popping of an asset price bubble, or excessively tight macroeconomic policies. If the demand shock is sufficiently large, it can undermine consumer and investor confidence, thus leading to further economic contraction and even more rapidly declining prices. The latter, a positive supply shock, may be associated with gains from productivity through technological innovation or gains from trade through liberalization.

Think of the difference as "bad" versus "good" deflation. If "bad" deflation accelerates, leading to a deflationary spiral, it can wreak havoc on an economy—as the United States learned during the Great Depression of the 1930s. Along with prices, wages and profits (and thus incomes) will fall. "Good" deflation, by contrast, should actually stimulate growth because it flows from increased efficiency.

There are some who believe Japan is enjoying, for the most part, "good" deflation. In 1999, the Bank of Japan (BOJ) produced a study concluding that price reductions have been concentrated in sectors such as telecommunications and distribution that have been subject to increased competition due to trade liberalization, deregulation, or "structural adjustments."[1] By the latter, the BOJ meant a process by which less efficient nonmanufacturing firms gradually lost their ability to extract subsidies, in the form of payments for hyper-expensive inputs, from more efficient manufacturing firms. It seemed to view deflation, then, as both a cause and effect of structural reform.

There are still others who believe Japan's current bout of deflation is the result of weak demand, but not a source of further weakening. That is, Japan is not caught up in a dangerous deflationary spiral. Richard Katz, for example, notes that consumer prices have fallen at an annual rate of only 0.5 percent in recent years—not a big deal.[2]

Most economists, however, do worry. In January of 2003, the Council on Economic and Fiscal Policy looked into its crystal ball and saw "bad" deflation hanging over the Japanese economy until at least 2005 or 2006, about two years longer than previously projected. It fretted that this would cause consumers and investors, angling for still lower prices, to postpone expenditures that might generate growth. In addition, the council expressed concern that deflation, if left unchecked, might handicap efforts by banks to clear up their nonperforming loans, estimated at more than US$1 trillion, and cripple efforts by the government to curb its massive and growing debt, valued at more than 140 percent of GDP. This is because deflation increases the real debt burden on borrowers.

For most economists, deflation can have another perverse and disconcerting effect: It often undermines the efficacy of monetary policy. Although nominal interest rates will, in most cases of "bad" deflation, fall with prices, they will never fall below zero. Indeed, as deflation accelerates, real interest rates will actually rise. Thus, if the demand for money is modest and relatively inelastic, no increase in the money supply will push interest rates down far enough to attract borrowers and thereby trigger increased output. This is the so-called liquidity trap.

The debate over deflation is no longer just an academic game, an intellectual contest waged by economists wielding charts and graphs. It has spilled over into the political arena. Deflation "hawks," including dozens of Japanese politicians and bureaucrats, have called for an aggressive mix of policy actions, including "inflation targeting" designed to break the back of deflationary expectations and "quantitative easing" designed to dramatically increase the money supply. But skeptics fear these antideflation measures will detract from the more fundamental task of restructuring the Japanese economy by clearing out nonperforming loans, squeezing out waste, and introducing efficiency. One such skeptic, Katz, has gone so far as to say that many deflation fighters are pushing these measures to bail out "backward" or inefficient industries that thrive on high prices. "Just as some politicians wanted to use public works to substitute for reform, so some see the same role for monetary easing that raises the price of stocks and real estate, and that finances the rollover of bank loans for the 'zombies'."[3]

Ironically, the politician who emerged as the leader of the fight against deflation had earlier led the charge for structural reform. I am, of course, speaking of Prime Minister Junichiro Koizumi, who called the effort to curb deflation Japan's "most urgent policy task." He promised to replace BOJ governor Masaru Hayami, who was widely viewed as "soft" on deflation by monetarist critics, with an aggressive "deflation fighter."

But in March of 2003, Koizumi tapped Toshihiko Fukui, a longtime BOJ official, for the top job at the bank. Fukui has proved cautious. At the first meeting of the BOJ policy board under his authority, the new governor said the BOJ should not be forced to absorb too much credit risk. Instead, it should pursue a careful approach that safeguards the health of the financial sector.

The voices for an aggressive program to counter deflation are well-represented in this issue of *The Japanese Economy*. They include Seiji Shinpo, who used to serve as an economist and vice minister in the government's Economic Planning Agency before joining a private think-tank and then taking up a teaching post at Aoyama Gakuin; and Takatoshi Ito, an economics professor at the University of Tokyo who used to serve as deputy vice minister in the Ministry of Finance (MOF). Shinpo is a strong advocate for quantitative easing, but also believes the government should continue to pursue structural reform of the economy. Ito fears the Japanese financial system will collapse if deflation continues unchecked for another five years; he calls for inflation targeting.

On the other side, this issue carries an article by Keiichiro Kobayashi, a younger economist affiliated with a think-tank run by the Ministry of Economy, Trade and Industry (METI); and a lecture by Hiroshi Kato, the president of Chiba University of Commerce. Both believe the government must move ahead with its agenda for reform, clearing up nonperforming loans (Kobayashi) and pursuing further deregulation and privatization (Kato). Although Kobayashi is more explicit, neither he nor Kato views deflation as the main culprit in Japan's economic stagnation.

Nominally, this issue represents my maiden voyage as editor of *The Japanese Economy*. In fact, though, it is really just a continuation of the theme ("Policy Choices") in the January–February 2002 (vol. 30, no. 1) issue, for which I was the guest editor. That issue included an insightful but controversial piece by Richard Werner, a Tokyo-based economist, that had both an economic message (that Japan's recent woes are due to a dramatic reduction in credit creation) and a political one (that the BOJ sanctioned this outcome, or fostered it, to carry out its objective of pushing structural reform—no matter how painful the results). For this current issue, I asked William Grimes, a political scientist at Boston University, to analyze Werner's piece,[4] especially its political message. He delivers a pointed critique, to which Werner responds.

Notes

1. Tsuyoshi Oyama, "Stagnation and Structural Adjustments of Nonmanufacturing Industries During the 1990s" (Tokyo: Bank of Japan, 1999). Available at www.boj.or.jp/en.ronbun/ronbun_f.htm. Robert Feldman, the economist, makes a similar argument in his essay, "Joe Friday and the CPI," in *Global Economic Forum* (January 14, 2002).
2. Richard Katz, *The Japanese Phoenix: The Long Road to Economic Revival* (Armonk, NY: M.E. Sharpe, 2003), p. 122.
3. Ibid., p. 119.
4. See Richard Werner, "The 'Enigma' of Japanese Policy Ineffectiveness: The Limits of Traditional Approaches, Not Cyclical Policy," *The Japanese Economy*, vol. 30, no. 1 (January–February 2002), pp. 25–95.

The Japanese Economy, vol. 31, no. 1, Spring 2003, pp. 7–13.

ISSN 1097–203X / 2004 $9.50 + 0.00.

TAKATOSHI ITO

How to Beat Deflation

Take Action with Unconventional Monetary Policies

Three Problems Caused by Deflation

The Japanese economy has been experiencing deflation ever since the spring of 1998 when the inflation rate, according to the Consumer Price Index (excluding fresh foods), fell below zero due to a slowdown that began in 1992 and a financial crisis that erupted in 1997.

Deflation presents three problems. First, it increases the real burden of debtors. For example, if an individual takes out a home loan expecting the rate of inflation or wage increase to rise by 2 percent, and the rate of inflation or wage increase actually decreases by 1 percent, the interest on the repayment of that home loan actually rises by about 3 percent more than anticipated. Naturally, this hinders consumption. Unanticipated drops in inflation essentially shift income from debtors to creditors. When this happens, the disposable income of debtors falls and the reverse asset effect goes into play, triggering reductions in consumption and investment. This process then contributes to a new generation of nonperforming loans.

Second, deflation limits the effectiveness of monetary policy by keeping real interest rates high. Since the nominal interest rate never falls below zero, the real interest rate (nominal interest minus inflation) is always positive by the amount of the deflation rate. When real interest rates remain positive even in a poor economy, monetary easing has no effect. Even if deflation is anticipated, investment and consumption are inhibited by high real interest rates.

Translation © 2004 M.E. Sharpe, Inc., from the Japanese original. Takatoshi Ito, "Infure taagetto o settei," *Ekonomisuto* (The Economist), April 14, 2003, pp. 15–19. Translated by Stacey Jehlik.

Takatoshi Ito is a professor of economics at the University of Tokyo.

vive the Fiscal Structural Reform Law with an amendment adding an elastic clause to counter cyclical fluctuations and present a long-term vision for fiscal reform. At the same time, the ministry should tolerate a temporary expansion of fiscal expenditures to prop up aggregate demand and facilitate structural reform, taking necessary measures to tackle unemployment and help small and medium-sized businesses as they face the threat of bankruptcy, an unavoidable result of bad loan disposal.

BOJ

To cope with the liquidity crises of corporate borrowers, the BOJ must be agile and flexible in boosting short-term money supply to prop up aggregate demand. Once the private sector economy is back on its feet, the BOJ should embark on price-support buying of government bonds, guide long-term interest rates lower, and prevent a plunge in government bond prices.

Judicial Authorities/Courts

It has been noted that the difficulty in preserving the debt claim priority in bankruptcy cases explains banks' inefficient lending activities, such as forbearance lending to nonviable borrowers and credit squeezes on other borrowers. The judicial authorities should reform bankruptcy proceedings to enable quick and efficient corporate reorganization and prevent inefficient corporate lending activities by banks. This would help reduce excessive private sector debt (before it is converted into government debt) and minimize the financial burden on taxpayers.

Economic Agencies

Government agencies should facilitate firms' entry into and out of markets by promoting deregulation and by enforcing the Antimonopoly Law. They should also encourage the formation of potential growth industries, such as information technology, financial engineering, and biotechnology, by providing support for technological development.

References

Bergoeing, R., P.J. Kehoe, T.J. Kehoe, and R. Soto. 2001. "A Decade Lost and Found: Mexico and Chile in the 1980s," Staff Report 292, Research Department, Federal Reserve Bank of Minneapolis.

Cochrane, J.H. 1998. "A Frictionless View of U.S. Inflation," NBER Working Paper 6646, National Bureau of Economic Research, Cambridge, MA.

Cole, H.L., and N. Kocherlakota. 1998. "Zero Nominal Interest Rates: Why They're Good and How to Get Them," *Federal Reserve Bank of Minneapolis Quarterly Review* 22: 2–10.

The Japanese Economy, vol. 31, no. 1, Spring 2003, pp. 69–81.

ISSN 1097–203X / 2004 $9.50 + 0.00.

William W. Grimes

Comment on Richard Werner's "The Enigma of Japanese Policy Ineffectiveness: The Limits of Traditional Approaches, Not Cyclical Policy"

Richard Werner's article "The Enigma of Japanese Policy Ineffectiveness" (*The Japanese Economy*, January–February 2002, vol. 30, no. 1) is an ambitious attempt to shape the terms of the economic debate over Japan's decade-long post-bubble economic stagnation. Werner argues that the source of the Japanese economy's ills has been misguided monetary policy. In doing so, he goes against a range of conventional wisdom, dismissing in particular arguments blaming lack of structural reform and poor fiscal policy management. The logic of his argument also differs in some important ways from that of other advocates of a quantitative easing solution to Japan's economic woes.

Werner's argument can be summarized in three rough categories. First is the economic diagnosis, which pins blame for the current situation on consistently inappropriate monetary policy. Second is the economic prescription, which calls for aggressive quantitative easing, particularly in the form of outright liquidation of banks' nonperforming loans (NPL's) by the Bank of Japan (BOJ). Third is a political diagnosis in which Werner argues that the BOJ was fully in control of monetary policy even well before the revised BOJ Law took effect in 1998, and that it has carried out irresponsible policies in hopes of forcing microeconomic reforms and without adequate democratic oversight. In this response, I focus mainly on Werner's political analysis, but it is impossible to do so without addressing the economic case.

William W. Grimes is an associate professor of international relations at Boston University.

The Role of Money in Japan's Lost Decade

Werner is definitely not alone in his focus on monetary policy as central to our story.[1] Indeed, it is difficult, if not impossible, to produce a credible explanation of the bubble and its aftermath without focusing at least partly on the role of money. In particular, while fiscal issues remain important to many observers, virtually all of them are sensitive to the interplay of monetary with fiscal policies. Some structural fatigue explanations (e.g., Katz 1998; Takenaka 1999) treat the bubble and its aftermath as almost unrelated to the longer-term stagnation of the 1990s. However, these efforts are unable to account for the timing of the bubble or the downturn, so even most authors who agree with their general point look to monetary and/or fiscal policies as important in inflating and bursting the bubble (Lincoln 2001; Gao 2001).

But if money-centered approaches to understanding Japan's problems are clearly in the mainstream, two things make Werner's story unusual. One is the exclusive focus on money over the entire bubble and post-bubble period, and the other is Werner's rejection of standard economic explanations of how monetary policy works in favor of his own analytical framework.

Werner works with a quantity theory of money in which money is defined as the sum of all economic transactions in the economy. One purpose of this exercise is to explain why the relationship of monetary aggregates to economic growth has been so volatile over the last couple of decades—his answer is that a great deal of money goes into transactions that, do not show up in gross domestic product (GDP), such as real estate transactions. Thus, when such non–GDP transactions plunge, so does the velocity of money relative to GDP. Another effect is that the model largely defines away the relevance of fiscal policy. Werner argues that all fiscal policy that is not accommodated by the creation of money leads to crowding out, and thus that monetary policy alone is responsible for the economic cycles.

Perhaps the most curious aspect of Werner's model is that, as he states clearly, "in this framework there is no role for interest rates" (p. 45). Werner starts with the accepted fact that credit rationing occurs in all functioning credit systems. As he points out, problems of adverse selection inevitably mean that bank lending is not always market-clearing in the short run. The conclusion that credit demand is not determinative at all in setting quantities of money lent through the system goes well beyond Stiglitz, however.[2] Credit rationing in a normally functioning system is not about quantity-based rationing at all, but rather about credit evaluation—banks do not lend based upon the amount that a borrower says s/he will pay back, but rather upon how much the bank believes the borrower will be able to pay back, discounted to its present value. Thus, most others who write about quantitative easing focus on it as a strategy only when nominal interest rates are too low to reduce any further (Bernanke 2000; Itō 2001; Shirakawa 2001).

In any event, an important implication of the model is that inappropriate monetary policy has led to significant crowding out in the Japanese economy. Werner wisely rejects Ricardian equivalence as a serious explanation of what is going on in Japan, based on both its assumptions of consumer hyperrationality and the overwhelming evidence against it in all economies and at all times. Instead of Ricardian equivalence, he argues that government borrowing reduces the private sector's ability to borrow as long as the central bank does not increase money commensurately. When there is no demand gap—or, as in Werner's formulation, if credit demand has nothing to do with credit supply—fiscal deficits will not accelerate growth. Of course, the central bank can choose to expand credit (which will lead to inflation only if there is no demand gap), but Werner argues that the BOJ has been singularly unwilling to do so over the last decade or so.

This is a rather bold statement, particularly as it does not require the central bank to actually raise money market rates to offset the stimulative impact of expansionary fiscal policy. This contradicts standard textbook views of the effects of fiscal policy, as well as analyses such as those of Kuttner and Posen (2001) and Ahearne et al. (2002) that find that fiscal policy had positive effects in the 1990s.

If fiscal policy is indeed capable of stimulating growth, a proposition that Werner essentially rejects, then a macroeconomic policy explanation of Japan's economic woes will look much more like the mainstream argument presented by authors such as Posen (1998 and 2000), Bernanke (2000), Cargill, Hutchison, and Ito (1997), Grimes (2001), and Ahearne et al. (2002). In this narrative, the bubble was fueled largely by overly expansive monetary policy from 1986 to 1989, a stance that was forced in part by the lack of fiscal support to deal with the recessionary impact of the appreciated yen. In 1989–90, monetary authorities acted vigorously to burst the bubble, and then only reluctantly eased policy in 1991–94 in response to the economic stagnation that followed. Fiscal policy was similarly slow to respond, despite apparently large fiscal stimulus plans in 1992, 1993, and 1994. The ultrahigh yen episode of 1995 created enough of a crisis mentality to spur positive action on both the fiscal and monetary fronts, but with the withdrawal of fiscal support in 1997, the economy crashed. Fiscal policy became active again in 1998 until around 2000 (depending on which author one reads), but monetary policy added little support. From 1999, the case for quantitative easing became increasingly clear to outside observers, but not even a nominal gesture was made by the BOJ until the March 19, 2001, Policy Board meeting, which produced a weak inflation target and called for an expansion of current account balances and of purchases of long-term government bonds. Subsequent Policy Board meetings have led to further steps in that direction, but most observers agree that they still do not constitute a really forceful quantitative easing policy.

To summarize the conventional view then, in addition to "exceptionally poor monetary policymaking over the past fifteen years" (Bernanke 2000, p. 150), fiscal policy has also been a major culprit. Also, monetary policy was defined largely by interest rate policies until at least 1995 or so, when the BOJ ran out of ammunition in that regard (Ahearne et al. 2002). Moreover, the failures of both macroeconomic and regulatory policy in the bubble and post-bubble years have created massive NPL stocks in Japan's banks, which have severely weakened the banking system's ability to create new credit.[3]

Before moving on, it seems important to reiterate that the key difference between Werner's model and those of other economists in the quantitative easing camp is that Werner rejects the existence of a clear relationship between price (interest rates) and quantity in credit markets. Thus, the story I have just summarized would be fundamentally incorrect—and indeed beside the point—in Werner's framework.

Moving to policy prescription, Werner focuses entirely on monetary policy—appropriately, given his analysis. Here, his basic monetary policy prescription has much in common with those of other quantitative easing advocates.

The more serious disagreement between Werner and many macroeconomists is over fiscal policy. As we have seen, Werner's analytical framework excludes fiscal policy from having a meaningful positive role. Werner also dismisses the positive effects of fiscal policy on empirical grounds, but other authors such as Kuttner and Posen (2001) and Ahearne et al. (2002) have found the opposite. It would be interesting to know how Werner assesses their empirical analyses. Moreover, fortunately—or rather, unfortunately for the Japanese economy—we do have the benefit of what we might call "experimental" evidence. I am talking about the FY 1997 fiscal consolidation, which served to plunge the Japanese economy into recession. Werner's own discussion of the 1997 contraction (pp. 65–66) focuses on the ineffectiveness of structural policies in promoting growth—although he mentions the fiscal consolidation efforts, they do not seem to figure into his analysis of the causes of the economic contraction.

One could certainly argue that fiscal policy is becoming increasingly dangerous as government debt mounts into stratospheric levels. One could also argue that the future dangers of stimulus are not worth the current benefits—although I personally disagree, this is a value judgment that should properly be left to Japan's democratic process. However, that is not what Werner is arguing. Rather, he argues that while the future danger is apparent, there is no current or past benefit. If he is correct, this is an important finding indeed.

The Politics of Japanese Macroeconomic Policy

Turning to Werner's political story, three points in particular should be borne in mind. First, since he largely dismisses the contribution of fiscal policy mistakes to Japan's stagnation, the various dramas over budget and tax policy disappear from his political story. So too do regulatory issues, although it may be possible to re-inject some financial regulatory policies into his explanation for the poor state of banks' balance sheets without doing violence to his analytical framework. Third, in pursuing his monetary policy story, he focuses exclusively on the role of the BOJ, which he views as having intentionally acted to produce a severe deflation in order to force "structural reform" in the economy.

The article presents several arguments concerning past, present, and future, not all of which I found convincing. Looking first at the period before the 1997 BOJ law revision, which for the first time granted the BOJ considerable formal autonomy, Werner states that the BOJ "since at least the late 1970s, has in practice independently decided the quantity of its credit creation" (p. 27). Werner also argues that BOJ monetary policy and preferences have been consistent at least since the governorship of Mieno Yasushi (1989–94; deputy governor, 1984–89). He also claims that BOJ window guidance in the late 1980s was a major force in promoting lending to the real estate sector.

Turning to the present, Werner attributes dangerous motives to BOJ policy makers, downplays their uncertainty, and appears to dismiss the possibility that they may have conflicting objectives. Throughout his discussion of past and present, Werner appears to assume that the BOJ has had perfect control of its actions. Such mastery is lacking in the real world. Moreover, since he does not buy the importance of fiscal policy, he is able to ignore the strategic gaming that has gone on at various times between the BOJ, the Ministry of Finance (MOF), and political leaders. In fact, I would argue that what he describes as a purely BOJ-induced mess is actually a tragedy caused by the structure of political interactions.

The Autonomy of the BOJ

Since at least the mid-1980s, there has been considerable debate about the functional autonomy of the BOJ. While observers often stated that the BOJ acted *as if* it were autonomous, this is not the same thing as stating that it actually *was* autonomous. Drawing on the extensive central bank independence literature, which has generally found that central bank independence correlates with low inflation, observers confronted the puzzle of how Japan had achieved very low rates of inflation despite having a central bank whose autonomy was rather weak on most of the indexes used to measure it.[4] While it is true that a number of economists, including Cargill (1989) engaged in some *ad hoc* hypothesizing to suggest BOJ autonomy, it was certainly not a consensus view.

Many of the authors who have written on this subject (including Werner and Cargill, as well as myself) were in close contact with the BOJ, where they heard about the bank's expanded autonomy from many of its officials. Certain stories were standard fare in that regard, such as the courage of Governor Maekawa Haruo in forcing through a discount rate hike in early 1980 while the cabinet budget draft was still being debated.[5] There were several problems with that type of evidence, however. One is that it was an attractive story for many people to tell—not only BOJ officials trying to add to their status, but also MOF and other government officials who wanted to project a modern and efficient image. More important, autonomy is only relevant where there is policy disagreement, which was not the case from the mid-1970s until the mid-1980s. While some economists have resorted to an unexplained MOF anti-inflationary bias to account for low inflation despite low central bank autonomy (e.g., Cukeirman, Webb, and Neyapti 1993, p. 28), that is not really necessary. A simpler story is that Japanese economic growth was strong enough that the ruling party did not need to artificially stimulate it through inflation.

What the apparently increasing BOJ autonomy of the Morinaga (1974–79) and Maekawa years (1979–84) masked was that significant external control mechanisms over the bank remained in place.[6] These mechanisms came into play when policy disagreements arose between the central bankers and the central government. To begin with, the BOJ's formal independence under the old BOJ law was indeed quite limited. The law provided for the bank to carry out policies "in the national interest," with the final arbiter of that interest being the MOF. The MOF and/or the Diet also had the power to appoint and dismiss the BOJ governor, to reject proposed changes in reserve requirements and in the official discount rate (the key interest rate during the era of window guidance), and to limit the amount of currency in circulation. Until FY 1988, postal savings interest rates were determined by the Ministry of Posts and Telecommunications in conjunction with the MOF, and bank lending rates were determined by an advisory committee to the MOF that was dominated by its MOF (and secondarily by commercial banks) members despite the official participation of the BOJ deputy governor. Moreover, by the late 1960s, a pattern of personnel exchanges had developed that clearly privileged the MOF in monetary policy making—pre-eminently, the alternation of MOF and BOJ officials in the governor and deputy governor positions and the usual inclusion of a MOF man in the old executive board.

Of course, the balance of power was not completely one-sided. The BOJ had some power to stall or resist policies that its internal leadership did not prefer, although its political capital was limited. The increasing use of open market and inter-bank operations from the mid-1970s or so onward meant that not all interest rate decisions were subject to MOF veto; this type of instrument independence expanded considerably with the end of managed bank lending rates in 1988. General market preferences also constrained very active MOF or political interference, as did the long-term necessity of working together with the BOJ. Thus, mutual restraint and cooperation were the norm, but when disagreements arose, the MOF (either of its own accord or based on pressures from the political world) could assert its own preferences and make them stick.

It is appropriate to note at this point that Werner does not actually reject this line of argumentation. Rather, as he clarified in a written communication in response to the first draft of this response, his argument is that while the BOJ was heavily constrained in *interest rate policy*, it still had complete control over *credit creation*. In other words, if Werner's economic argument is correct *and* the BOJ's weak political position did not extend to credit supply, then the preceding paragraphs do not constitute a critique of Werner's assignment of blame to the BOJ. Leaving aside for now the question of whether it really is appropriate to separate price and quantity when it comes to monetary policy, it seems very odd that an

institution that was so constrained in all of its other policies should have been left completely unconstrained in the one area that Werner claims to have been most crucial. In this respect, it would be helpful to see a fuller discussion of how Werner understands this mechanism to have worked.

If we do not accept the argument that interest rates and credit creation were functionally separate, then in order to make meaningful statements about the autonomy of the BOJ, we need to consider instances in which its monetary policy preferences diverged from those of the MOF or the political leadership. For the purposes of evaluating Werner's assertions, the most appropriate periods are 1986–93 and 1999–2002; conveniently, these periods fall into the broader pre–BOJ law revision and post-revision periods. Analysis of events in these periods leads to the conclusion that the bank's levels of autonomy were qualitatively different in the two periods.

To begin with the bubble, a whole range of studies and memoirs has asserted that the bank's leadership objected to the easy money policy by late 1986 and that the BOJ was forced to extend and then maintain it (Mieno 2001; Ohta 1991; Ogata 1996; Tachi et al. 1993). This is not just *post hoc* justification by policymakers of their own mistakes; prior to the discount rate cut of October 31, 1986, the BOJ had not only been allowing interbank rates to rise gradually over the course of the summer (a *takame yūdō* in BOJ parlance), but then-Deputy Governor Mieno had publicly stated before the Diet the need to raise interest rates. How then do we explain the contradictory decision to *lower* the discount rate (which was accompanied by across-the-board cuts in other rates)? This is actually not very difficult, if we simply note that the interest rate cut was tied to the Baker-Miyazawa Agreement. Although Governor Sumita Satoshi was not involved in the negotiation, the fervent wish of the finance minister gave the bank's leadership little choice but to cooperate, despite its preference for leaving adjustment to the fiscal authorities.

The extended low-interest period was similarly not an autonomous choice of the BOJ leadership. While Werner accuses Fukui Toshihiko of forcing banks to lend large amounts to the real estate sector during the bubble, in point of fact BOJ publications throughout 1988 and early 1989 were raising alarms about the wild asset price rises. (In any event, banks hardly needed encouragement to shift their lending to the highly lucrative real estate sector, as disintermediation meant the loss of top clients at the same time that deposits were burgeoning; see Hoshi and Kashyap 2001, especially pp. 241–48 for some figures.) Besides, window guidance established an upper limit on direct BOJ lending to banks, and could only expand total credit to the extent that banks desired to lend the money domestically. A more credible explanation for the temporal extension of loose money policy well past West Germany's post–Black Monday interest rate hike of early 1988 is that the BOJ was constrained, whether by "international obligations" as Mieno (2001) delicately puts it or by the fact that MOF's fiscal policy was going in the opposite direction and only monetary policy was left to deal with the problems of the Japanese economy, as MOF-sponsored study by Tachi et al. (1993) suggests.[7]

The suddenly restrictive monetary policies of 1989–90 would appear to fit Werner's political story better, but given the clear indications of BOJ weakness in 1986–89 it hardly seems conceivable that the BOJ suddenly became more autonomous in May 1989. There is a far simpler reason why it became able to aggressively act against the asset price bubble: The bubble was no longer politically useful. With the economy growing rapidly, MOF bureaucrats had no reason to fear that tighter money would require looser fiscal policy; meanwhile, popular sentiment about speculators combined with the effects of the recruit and other stock-ramping scandals to make a bursting of the bubble politically palatable. With no major actors opposing higher interest rates in 1989, the BOJ was finally free to do what it saw as appropriate. The extraordinary speed with which the bank raised interest rates from May 1989 to August 1990 made it clear that decision makers felt that they had fallen behind the curve. But it also had a *strategic* aspect. The BOJ, constrained as it was by other actors, needed to tighten money or it might find itself unable to tighten later on—in other words, it had a political incentive to overshoot on tightening.

Pressure to begin loosening monetary policy did indeed come quickly, with the drumbeat becoming audible by late 1990. Then, despite consistent public statements by BOJ leaders and publications that there was nothing wrong with the Japanese economy, the BOJ began to lower interest rates from July 1991. Lowering was reluctant and probably slower than it should have been; moreover, it came without any serious fiscal support until FY 1993 (although some may argue that the August 1992 fiscal stimulus package had at least some impact).[8] These patterns are simply not consistent with an autonomous central bank as it is usually understood.

Contrast the 1986–94 pattern with that of 1999–2002. When the BOJ raised interbank rates from nearly zero percent to 0.25 percent in August 2000, it did so in the face of massive public and private pressure. Indeed, Finance Minister Miyazawa Kiichi himself went to the Policy Board meeting to request postponement of the hike (the finance minister having lost the right to demand postponement with the 1997 BOJ law revision) while top LDP and cabinet officials publicly fumed about the irresponsibility of the move—all to no avail. Similarly, while the BOJ has become increasingly isolated in its positions regarding quantitative easing (as effectively documented by Werner), it has continued to resist. With no recourse under the current BOJ law, threats have mounted to amend the law, but that is a time-consuming and uncertain process.

Even in the current situation, however, the BOJ is not entirely deaf to outside pressures. In its March 19, 2001, meeting, the BOJ Policy Board decided to carry out limited quantitative easing measures in the form of increasing purchases of government bonds and of targeting a higher level of current accounts at the bank, along with a weak attempt at inflation targeting. The quantity targets have subsequently been raised several times. However, despite the technical nod toward quantitative easing, top officials (especially former Governor Hayami) have continued

to argue that they are essentially worthless in monetary policy terms, which has probably not done wonders for the credibility of the policies. (In Werner's analysis, these are, of course, not nearly as assertive in either quantity or type as they should be.)

Structural Reform, Moral Hazard, and BOJ Policies

Werner's political analysis of BOJ policies identifies a consistent bank objective of promoting structural reform in the Japanese economy as the reason for its inappropriate monetary policies. It is certainly the case that governors Mieno and Hayami have been rather vocal about the benefits of deflationary policy in eliminating inefficiencies. And few if any macroeconomists have sympathy for the Mieno-Hayami argument that monetary policy is an appropriate instrument for promoting structural reform or for the assumption that central bankers have a role in such micro matters (Bernanke 2000; Posen 2000). Nonetheless, there are problems with the way in which Werner formulates this argument.

First, the suggestion that structural reform has consistently been the central objective of BOJ leaders since 1989 is problematic. For one thing, while it is probably the most distinctive justification made, it is by no means the only—or even the most consistent—one put forward publicly. Far more common have been warnings of the possibility of a resurgence of inflation. This was particularly true in the early 1990s, when Mieno was resisting monetary easing; while he did bring up the need for structural reform (particularly in retrospect, as in Mieno 2001), the main focus was on changes that would discourage asset price inflation. Similarly, while some of the BOJ studies over the last few years warning that quantitative easing might create unacceptably high inflation may seem to be disingenuous, the fear of revived inflation does appear to run deep in the BOJ psyche (Okina 1999). Bad analysis it may be (and on this point I agree with Werner), but it does complicate the question of BOJ intentions.

Moreover, where structural reform and efficiency questions do appear in BOJ statements—which is, admittedly, often—they are not always in accord with the popular understanding of those catchphrases. BOJ structural reform preferences have two main foci: the resurgence of asset inflation (particularly in the early post-bubble years) and the reduction of moral hazard. In other words, the motivation is not purely Higuchi Commission redux, with its focus on government efficiency and elimination of entry barriers in specific industries (Takenaka 1999). Rather, the bank's leaders have focused on those issues that have tended to constrain it politically in the past.

As I have argued, the BOJ has a history of being constrained in its ability to produce an autonomous monetary policy, often with negative effects on the quality of its policies.[9] Until the 1990s, the major errors for which the bank was blamed produced excessive inflation, and a strong anti-inflationary sentiment resulted that was reinforced by internal promotion patterns. If poor inflationary performance had a negative effect on BOJ prestige and autonomy, however, a far more important influence was the MOF, which systematically constrained its activities. (In this regard, Ahearne et al.'s [2002] emphasis on the asymmetrical nature of the risk of deflation vs. inflation flies in the face of the BOJ's understanding of the asymmetrical *political* risk.)

To some extent, the BOJ's current resistance to the various forms of quantitative easing can indeed be read as pure bloody-minded and short-sighted assertion of its autonomy (e.g., Bernanke 2000). But I would suggest that even the obstinate Mr. Hayami was not *just* trying to establish precedent for future interactions with the government, although that appears to have been an important element. BOJ resistance to easy money has focused on areas that will tend to threaten its long-term autonomy. For example, the very strong reticence about becoming a lender to the government reflects nervousness about the possibility of losing control in the future to a government that has become addicted to not having a budget constraint. Similarly, the bank's reluctance to purchase large amounts of foreign exchange on its own account may reflect a fear of being scapegoated by the United States or by politicians if the fall of the yen produces negative political repercussions—it is far more convenient to leave that choice up to the MOF (which itself does not appear to be eager to take responsibility). In these policies, we see not recklessness *per se*, but rather blame avoidance and risk aversion run amok. While this does not make for good policy, it also does not constitute the kind of intentionally dangerous policy that Werner posits.

We can see institutional logic at work in the BOJ's reluctance to bail out the banking system as well. Werner argues that the BOJ should simply buy out much of the nonperforming debt in the banking system and monetize it—"the central bank, in fulfillment of its function, [should] solve the bad debt problem in the banking system by conducting a one-off purchase operation of all declared bad debts from the banks at the original book value" (p. 58). He suggests, moreover, that this would be a costless policy.[10] But while the bank has been willing in virtually all individual cases to put up "special loans" (*tokuyū*) for failing banks and to support recapitalization, it has consistently preferred to have the government deal with NPL disposal. For Werner, the puzzle is why. He dismisses moral hazard as a reason not to do so, but the BOJ does seem to take this problem seriously—neither the BOJ nor most observers of whom I am aware have confidence that banks will significantly improve their risk management just because they are no longer hemorrhaging money. If today's bail-out is not likely to prevent tomorrow's problems, then it makes no political sense for the BOJ to take responsibility for it now. (Unfortunately, the same holds for the government's Resolution and Collection Corporation and Financial Services Agency as well, which have not been effective to date in disposing of NPL's.) Moreover, having on its books trillions of yen in loans to firms—some of them highly politically connected—inevitably would put the BOJ in the political position of choosing which ones to roll over or to bring to bankruptcy court. While that would give it an unprecedented opportunity to effect structural reform throughout the economy, it is not an opportunity that even former Governor Hayami would have found appealing, at least partly because it would draw the BOJ into a political arena where its autonomy in virtually every function would be threatened.

If we accept the possibility that the BOJ leadership means much of what it says and not just the things it says about structural reform, we can consider the possibility that it really *does* care about moral hazard in its dealings with banks, the financial markets, and government finance. When we combine that with the observation that there are clear institutional incentives toward blame avoidance and risk aversion, the bank's preferences in the quantitative easing debate become less obscure.

In Closing

Werner's goals in his "The Enigma of Japanese Policy Ineffectiveness" article are ambitious. He seeks to reshape the debate over the problems of the Japanese economy, and proposes bold economic and institutional prescriptions for fixing them. Along the way, he engages with virtually every major economist writing on those subjects.

In the end, his article relies on three arguments: the separability of interest rates and credit creation, BOJ control over money supply even when it was constrained in virtually all other functions, and a single-minded BOJ emphasis on structural reform as the primary determinant of monetary policy for over a decade. Each of these is debatable. While Werner's work is interesting and often thought-provoking, I for one remain unconvinced.

Notes

1. See, inter alia, Tachi et al. 1993; Krugman 1998; Bernanke 2000; Posen 2000; Cargill, Hutchison, and Ito 1997; Ito 2001; Ahearne et al. 2002.

2. Consider, for example, Stiglitz and Greenwald (1993), which directly addresses the theoretical and practical problems of monetary policy when banks are risk-averse. While some of their conclusions are similar to Werner's, their point is that monetary easing has weak effects when banks become more risk-averse (i.e., when there is a change in banks' risk tolerance). Thus, their analysis would not support a general statement as to the lack of a relationship between credit price and quantity. Moreover, even in the recessionary, risk-averse banking environment they address, they do demonstrate some—albeit weak—effects of rate cuts.

3. This point is clearly in line with Werner's own analysis as well.

4. Using the standard criteria found in Cukierman, Webb, and Neyapti (1993) and Eijffinger and de Haan (1996) yields a level of autonomy roughly the equivalent of the Belgian central bank.

5. The ubiquity of this story—told to me over the years by both Bank of Japan (BOJ) and Ministry of Finance (MOF) officials, and even brought up in then-Finance Minister Takeshita Noboru's (1991) and then-Deputy Governor Sumita Satoshi's (1992) memoirs—is if anything an indication of the slenderness of the reeds on which the BOJ was building its self-image of autonomy. Economically, the decision was a simple one since Japan needed to respond to the effects of the second oil shock. Moreover, since it was a discount rate cut,

it would actually reduce the budget burden of the government, which was less controversial than raising it. Finally, of course, the tradition that monetary policy was expected to remain frozen for a quarter of every year in deference to budget debate was an artifact of the political subordination of the BOJ.

6. The following discussion draws extensively from Grimes (2001), especially chapter 2, where more complete primary source citations can be found. See also Mabuchi 1994 and 1997.

7. There were in fact no formal "international obligations" regarding monetary policy in 1988–89. Mieno is referring obliquely to the combination of U.S. and MOF pressures regarding Japanese domestic demand, but domestic demand could also have been addressed by fiscal policy. Incidentally, Werner (pp. 64–65) refers to the 1986 Maekawa Report, led by the former BOJ governor. The report for the most part faithfully reflects the interests of the bureaucracies whose retirees wrote it—and in the case of macroeconomic policy, it clearly favors the MOF position of fiscal consolidation while calling for "flexible" monetary policy to deal with any contingencies.

8. For a recent analysis of both fiscal and monetary policy at this time, see Ahearne et al. (2002).

9. The usual examples given within the BOJ are the inflation of 1973–74 (generally understood to have been pushed onto Governor Sasaki by then-Prime Minister Tanaka Kakuei) and the bubble-era easy money from fall 1986 to spring 1989.

10. A different version of this policy would be for the government's Resolution and Collection Corporation to purchase the loans, securitize the payments streams, and then sell the bonds at face value to the BOJ. This would eliminate the logistical problem of having the central bank acting as loan officer to thousands of construction firms, but the general concept is the same.

References

Ahearne, Alan, Joseph Gagnon, Jane Haltmaier, and Steve Kamin. 2002. "Preventing Deflation: Lessons from Japan's Experience in the 1990s." Board of Governors of the Federal Reserve System, *International Finance Discussion Papers*, No. 729 (June).

Bernanke, Ben. 2000. "Japanese Monetary Policy: A Case of Self-Induced Paralysis?" In *Japan's Financial Crisis and Its Parallels to U.S. Experience*, ed. Ryoichi Mikitani and Adam Posen, pp. 149–66. Washington, DC: Institute for International Economics.

Cargill, Thomas. 1989. "Central Bank Independence and Regulatory Responsibilities: The Bank of Japan and the Federal Reserve." Salomon Brothers Center for the Study of Financial Institutions, *Monograph Series in Finance and Economics*, no. 2.

Cargill, Thomas, Michael Hutchison, and Takatoshi Ito. 1997. *The Political Economy of Japanese Monetary Policy*. Cambridge: MIT Press.

Cukierman, Alex, Steven Webb, and Bilin Neyapti. 1993. "Measuring Central Bank Independence and Its Effect on Policy Outcomes." International Center for Economic Growth, *Occasional Papers*, no. 58.

Eijffinger, Sylvester, and Jakob de Haan. 1996. "The Political Economy of Central Bank Independence." Princeton University International Finance Section, *Special Papers in International Economics*, no. 19.

Gao, Bai. 2001. *Japan's Economic Dilemma: The Institutional Origins of Prosperity and Stagnation*. Cambridge: Cambridge University Press.

Grimes, William W. 2001. *Unmaking the Japanese Miracle: Macroeconomic Politics, 1985–2000*. Ithaca: Cornell University Press.

Hoshi, Takeo and Anil Kashyap. 2001. *Corporate Financing and Governance in Japan: The Road to the Future*. Cambridge: MIT Press.

Itō, Takatoshi. 2001. "Kin'yū seisaku no mokuhyō to shudan" (The Goals and Procedures of Monetary Policy). *Economics and Policy* (May): 30–38.

Katz, Richard. 1998. *Japan: The System That Soured*. Armonk, NY: M.E. Sharpe.

Krugman, Paul. 1998. "Japan's Trap." Available at web.mit.edu/krugman/www.japtrap.html.

Kuttner, Kenneth, and Adam Posen. 2001. "Passive Savers and Fiscal Policy Effectiveness in Japan." Paper presented at CEPR-CIRJE-NBER Conference on Issues in Fiscal Adjustment, Tokyo, December 13–14.

Lincoln, Edward J, 2001. *Arthritic Japan: The Slow Pace of Economic Reform*. Washington, DC: Brookings Institution.

Mabuchi, Masaru. 1994. *Ōkurashō tōsei no seiji keizaigaku* (The Political Economy of Ministry of Finance Control). Tokyo: Chūō kōronsha.

———. 1997. *Ōkurashō wa naze oitsumerareta no ka?* (Why Is the Ministry of Finance on the Run?). Tokyo: Chūō kōronsha.

Mieno, Yasushi. 2001. *Ri o mite, gi o omou* (Pursuing Gain, Remembering Duty). Tokyo: Chūō kōronsha.

Ogata, Shijūrō. 1996. *En to Nichigin: Sentoraru bankā no kaisō* (Yen and BOJ: Memoirs of a Central Banker). Tokyo: Chūō kōronsha.

Ohta, Takeshi. 1991. *Kokusai kin'yū: Genba kara no shōgen* (International Finance: Testimony from the Scene). Tokyo: Chūō kōronsha.

Okina, Kunio. 1999. "Monetary Policy Under Zero Inflation: A Response to Criticisms and Questions Regarding Monetary Policy." *Monetary and Economic Studies*, (December). Tokyo: Bank of Japan.

Posen, Adam. 1998. *Restoring Japan's Economic Growth*. Washington, DC: Institute for International Economics.

———. 2000. "The Political Economy of Deflationary Monetary Policy." In *Japan's Financial Crisis and Its Parallels to U.S. Experience*, ed. Ryoichi Mikitani and Adam Posen, pp.194–208. Washington, DC: Institute for International Economics Special Report.

Shirakawa, Masaaki. 2001. "Zero kinri seiyaku to B/S chōseika no kin'yū seisaku" (The Monetary Policy Under Zero Interest Rate Constraint and Balance Sheet Adjustment). *Economics & Policy* (May): 39–52.

Stiglitz, Joseph, and Bruce Greenwald. 1993. "Monetary Policy and the Theory of the Risk-Averse Bank." *Working Papers in Applied Economic Theory*. No. 93–04. San Francisco: Federal Reserve Bank of San Francisco.

Sumita, Satoshi. 1992. *Wasuregataki hibi: Nana jū go nen* (Unforgettable Days: Seventy Five Years). Tokyo: Kin'yū keizai jijō kenkyūkai.

Tachi, Ryuichiro, et al. 1993. *Shisan kakaku hendō no mekanizumu to sono keizai kōka* (The Asset Price Fluctuation Mechanism and Its Economic Impacts). Tokyo: Ministry of Finance, April.

Takenaka, Heizō. 1999. *Keiseisaimin* (Government for the Good of the People). Tokyo: Diamondsha.

Takeshita, Noboru. 1991. *Shōgen: Hoshu seiken* (Testimony: Conservative Governance). Tokyo: Yomiuri shimbunsha.

The Japanese Economy, vol. 31, no. 1, Spring 2003, pp. 82–96.

ISSN 1097–203X / 2004 $9.50 + 0.00.

RICHARD A. WERNER

Response to William W. Grimes, "Comment on Richard Werner's 'The Enigma of Japanese Policy Ineffectiveness: The Limits of Traditional Approaches, Not Cyclical Policy'"

Grimes claims to "remain unconvinced" by my argument that the Bank of Japan (BOJ) had been very much in the driver's seat of monetary policy during the 1990s and that its desire to promote structural reform provided a main motivation for taking policies that would prolong the recession. Grimes makes a last stand for the view that the BOJ has been so "constrained" in its monetary policy that the Ministry of Finance (MOF) must have been in charge (and thus mainly responsible for policy mistakes). This story has been propagated by the BOJ and frequently—usually uncritically—cited by the press over the past decade. At the same time, Grimes may already be more convinced by my arguments than he chooses to admit here. Since our exchange of views concerning this topic in early 2002, he elsewhere now endorses my argument that the BOJ has, indeed, been aiming at structural reform and that its "quantitative policy" was used for this purpose (Grimes 2002). More about that later.

First, on a fundamental level, Grimes does not appear to appreciate that an important motivation for my article has been the challenge that the Japanese macroeconomic record of the 1990s posed to standard economic theories. Grimes seems unaware of such a challenge and thus fails to acknowledge that my framework solves what otherwise remains a puzzle. Among other things, I explain why no lasting recovery was achieved despite a decade of interest rate reductions (because the quantity of credit did not expand), significant fiscal stimulation (because fiscal policy does not create credit), increases of high-powered money, the so-called money supply or bank reserves with the central bank (none of them necessarily imply expanding credit creation), and far-reaching structural reforms (they do not address the reason for the recession, a lack of credit creation).

Richard A. Werner is assistant professor of economics, Sophia University (Tokyo), and chief economist, Profit Research Center, Ltd. (Tokyo).

Instead, we are told that "Werner works with a quantity theory of money in which money is defined as the sum of all economic transactions in the economy." This is inaccurate. I remind the reader that the amount of money exchanging hands to pay for transactions is as large as the value of these transactions. Economic growth means that there must be more transactions during this period than before. This requires that more money is used. That leads us to the critical question: How can the amount of money used for transactions increase? On the surface, the answer appears trivial: Consumers could simply withdraw their savings and spend more. However, at any moment in time savings are invested. If I sell my stocks in order to spend more, then I simply obtain money from those investors who bought my stocks. While my consumption increases, the money is withdrawn from alternative uses. There is thus no net growth. The only exception would be if increased spending is funded by running down otherwise idle cash reserves. However, the reality is that cash holdings amount to a tiny fraction of all transactions, even in Japan. The majority take place as noncash bank transfers. This brings us to the most important point: The two main actors that can increase the net amount of money used in the economy are the central bank and the banking system. Both can create new purchasing power out of nothing, through credit creation. For the net amount of transactions to increase, credit creation must occur. This provides the explanation to Japan's "puzzling" problems, and their only solution. The excess credit created by banks in the 1980s was used speculatively (thus boosting asset prices), but had to turn into bad debts as soon as bank credit slowed. This rendered banks risk-averse and unwilling to lend. As bank credit slowed further, so did economic growth. The necessary and sufficient condition for a recovery is an increase in credit creation, which can take the form of central bank or commercial bank credit creation.

Although there are many things the BOJ could have done to create a recovery at any time since the early 1990s, it chose not to do so. Just after 1945, the BOJ demonstrated how a quick recovery can be created, even when virtually one hundred percent of bank assets are nonperforming. At the time, the BOJ was keen to quickly boost the economy. So it increased its purchases of private sector assets (bills, bonds, etc.), lent directly to the economy, and solved the bad debt problem at zero cost (by buying bad debts from banks at prices in excess of their market value). During the 1990s, BOJ gave us a long list of excuses why none of these policies could be implemented. But those excuses don't stand up to close scrutiny. The only rational reason left to explain the BOJ's actions is its senior staff's repeated claim that the goal of monetary policy has not been to create a recovery in the short-term, but to engineer "long-term sustainable" growth. That, we are told, is only possible after deep structural changes (even a "structural transformation," according to Mieno), which would not come about if the economy recovered quickly. Thus the inevitable, if uncomfortable, conclusion is that the BOJ has purposely prolonged the recession to implement what amounts to a political agenda, namely to change Japan's economic structure.

The Role of Fiscal Policy and Interest Rates

But back to Grimes' comments. He says that my "model largely defines away the relevance of fiscal policy." Instead, it correctly identifies the actual relevance of fiscal policy. Since we all agree that fiscal policy does not in itself create new purchasing power, and even the Ministry of Finance (MOF) is bound by the budget constraint of having to raise money to fund its spending, any increase in fiscal spending can only transfer existing purchasing power from A to B (namely from investors buying government bonds to construction firms receiving government orders). Thus far from being irrelevant, stimulatory fiscal policy has the important effect of reducing private sector purchasing power, yen by yen. In other words, I clarified the neglected fact that fiscal policy cannot help the economy, if the national income pie is fixed (by a fixed amount of credit creation). In that case, an increase in the government share of the given pie means that the private sector share falls. Fiscal policy not backed by the creation of new credit merely diverts existing purchasing power and hence cannot result in net economic growth. Grimes fails to acknowledge that this thesis is supported by empirical evidence and also explains why a decade of significant fiscal expansion has not boosted the Japanese economy.

Grimes is correct in arguing that my model "contradicts standard textbook views of the effects of fiscal policy." This is no critique, however, especially if he acknowledged that textbook models could not explain Japanese macroeconomic performance. Instead of engaging in an argument concerning my model, Grimes merely goes on to recite the traditional story about the role of fiscal policy, without attempting to explain why fiscal policy has been ineffective. A feeble attempt is his claim that until 1994, fiscal policy was "slow to respond." Similarly, the lack of response to repeated interest rate reductions is apparently due to a "reluctant" and "belated" easing. A more serious examination of the actual data is required. In this context, it is important to define fiscal policy accurately. In my test, I use actual government spending, as recorded by the national income accounts. This is shown in Figure 3 of my original article, which already indicates that increases in fiscal spending (significant even before 1994) went hand-in-glove with reductions in private demand. Grimes fails to comment. Also by the measure of the surging national debt it is obvious that Japan has engaged in sizeable fiscal stimulation, but with little to show for it. Unlike alternative models, mine explains why: Due to lack of credit creation, one yen in government spending crowded out private demand by one yen.

Grimes asserts that the 1997 fiscal tightening was the reason for the economic slowdown that year. The NIA data show that government spending declined in 1996 (when gross domestic product [GDP] jumped) and rose again, modestly, in 1997. In any case, my model explains the 1997 downturn by the sharp fall in credit creation. To decide which explanation is preferable, both should be tested. While I do that (by directly testing the impact of fiscal spending on private demand, controlling for credit creation), Grimes does not and also fails to comment on my findings.[1]

Grimes considers it a "curious aspect of Werner's model" that there is no role for interest rates in this framework. Why? Grimes seems unaware that interest rates are part of the general empirical model that I start out with, but when I reduce it to the parsimonious form, interest rates drop out as insignificant. This is not unusual. There is overwhelming evidence that interest rates fail to explain economic growth in many countries and are often eliminated from parsimonious econometric models for lack of explanatory power. The theoretical literature also has long moved on from the simplistic equilibrium models where perfect information, immediate price adjustment and zero transaction costs ensure that demand always equals supply and hence prices and quantities are in a unique relationship. My model does not require such heroic assumptions. Without them, we cannot expect markets to be in equilibrium. In that case, they are rationed, and thus quantities dominate and don't necessarily move inversely to prices.

Grimes unconvincingly argues that "credit rationing in a normally functioning system is not about quantity-based rationing at all." The *Oxford Dictionary* defines a "ration" as a "fixed quantity . . . allowed to one person" and "to ration" as "to limit (somebody) to a fixed ration." Even his own explanation that credit rationing is supposed to be about "how much the bank believes the borrower will be able to pay back" refers to a quantity. If an increasing number of firms are credit-rationed (say, due to higher risk-aversion of banks burdened with bad debts), credit growth is likely to fall, no matter what happens to interest rates (for an early warning that this would happen, see Werner 1991; for a demonstration that credit is the main explanation of nominal GDP, see Werner 1992, 1997). Grimes might also wish to read some of the many papers by Stiglitz and his collaborators on the topic.

Quantitative Easing and Inflation Targeting

Grimes argues that my monetary policy prescription "has much in common with those of other quantitative easing advocates."[2] He appears not to recognize a crucial difference between my framework and that of others (such as the widely circulated models by Krugman 1998, or Takatoshi Ito). Recognizing this difference is important for understanding the problem with the much-discussed proposal to introduce an inflation target. Most of the advocates of inflation targeting argue that quantitative easing would work through raising inflationary expectations (due to the announcement of expanded central bank open market purchases to meet the target), which would reduce real interest rates and thus stimulate the economy. I point out that in this framework, unlike in mine, there is no actual physical mechanism by which monetary policy is transmitted. It all depends on making people believe that there will be inflation. This is of course why this proposal is rejected by the Bank of Japan. If there are ingrained deflationary expectations or, worse, if agents are just as "rational" as Krugman's model assumes, then they should also "know" that there is no physical mechanism by which the Bank of Japan can stimulate the economy and that it is merely trying to fool them into believing that there will be inflation. Hence, says the BOJ, an inflation target is not credible and thus can't work.[3] This argument has not been successfully countered by the "expectations" camp.

My framework, however, shows that quantitative easing in the form of increased credit creation would work, irrespective of expectations. If the BOJ increased the quantity of credit creation (for instance through increased CP and bond purchases, as happened in March 1998, when its credit creation reached a twenty-five-year high), *ceteris paribus* economic growth will expand, no matter what is expected. The empirical record backs my model: Since there is no evidence that the surprise recovery of 1999 and 2000 was expected by the majority of forecasters, it is clear that expectations had nothing to do with it, just as my model argued (the same applies to the surprise growth of 4 percent in 1996, which I correctly predicted based on credit creation, but which surprised most other forecasters). Grimes remains silent on all this.

The BOJ's Independence

Turning to the central bank's independence, Grimes correctly recognizes my argument that in the 1990s the Bank of Japan had independently decided the quantity of its credit creation. But he claims: "Throughout his discussion of past and present, Werner appears to assume that the BOJ has had perfect control of its actions." To the contrary, I argue that the old Bank of Japan law gave MOF legal control over monetary policy, which it often exerted in the determination of interest rates. However, the Bank of Japan succeeded in maintaining autonomy, because MOF (and many observers) were unaware that the crucial monetary policy variable was the quantity of credit. Through actual control over this variable, the central bank autonomously prolonged the recession. I do not *assume* any of this, but report results of empirical research to this effect, listed in the bibliography. Grimes simply asserts: "Such mastery is lacking in the real world." To be taken seriously, he needs to show that the Bank of Japan was not in control of the quantity of its credit creation. Nowhere does he do so. There is no evidence that the Ministry of Finance had influenced the central bank's credit creation. Indeed, the net purchase transactions of the central bank have not even been discussed during BOJ policy board meetings, yet they vary on a monthly basis (and are in no particular relationship with interest rates, as I show in my article). If Grimes disagrees, I welcome his evidence. But is he really arguing that the Ministry of Finance used its legal status to *prevent* the Bank of Japan from expanding the quantity of credit during

the 1990s, as his logic suggests? Unlikely. As it is, Grimes has no grounds to doubt my empirical finding that the quantity of credit has been under the BOJ's autonomous control. His assertion that "Such mastery is lacking in the real world" is baseless.[4]

Concerning the control over bank credit, Grimes seems unaware that there has been a consensus among Japan economists that window guidance has been the key monetary policy tool until the early 1980s and that through it the BOJ determined bank credit creation without interference from the MOF, the government, or politicians (see, for instance, Patrick 1962; Kure, 1973; Horiuchi 1993). My research updated this finding and showed it to be true also for the 1980s and early 1990s (Werner 1998, 1999a, b, 2001, 2002, 2003a, b), rendering the BOJ directly responsible for the real estate-related lending that produced the bubble. My finding has remained undisputed, including by the BOJ, and is approvingly cited in the literature on the issue (Okazaki 2002).

Grimes seems to believe that window guidance merely established an "upper limit" on credit growth. Such myths have long been discarded in the literature and Grimes would do well to familiarize himself with the facts. Window guidance was a quota that had to be fulfilled and banks struggled to meet sometimes outlandishly high quotas imposed on them by the BOJ as they sought to avoid costly penalties for noncompliance. Since MOF is not shown to have had any influence on window guidance, or credit creation in general, Grimes' assertion that the MOF "systematically constrained [the BOJ's] activities" does not gain validity through frequent repetition.[5]

Grimes' case is reduced to his citation of the well-known lack of legal independence enshrined in the old BOJ law, and MOF's well-known influence over interest rates. Having completely evaded the crucial issue—the BOJ's control over the quantity of credit creation—Grimes can only come up with the statement that "it seems very odd that an institution that was so constrained in all of its other policies should have been left completely unconstrained in the one area that Werner claims to have been most crucial." I find it surprising that a political scientist would consider this "very odd." Once we recognize quantity of credit as the key variable, would the BOJ, as a political actor, not attempt to maintain control over it? By engaging in precisely the type of obfuscation which dominates its publications, the BOJ could claim that monetary policy is made exclusively by short-term interest rates, no matter that these cannot not explain growth and no matter that after decades of reciting this mantra, the BOJ discarded it unceremoniously in March 2001. Would Grimes expect a political actor, who as yet remains in unrestricted control of a certain important power lever, to (a) obfuscate its role and function in public in order to maintain discretion over its use or (b) explain its importance to the world and thus lose discretion and perhaps also control over it? Especially given the BOJ's weak legal position, it surely acted rationally from the perspective of maximizing its actual independence—a phenomenon Friedman (1982) identified in the United States.

Although Grimes claims to "evaluate" my analysis of the BOJ's policy autonomy by choosing two time periods, 1986–93 and 1999–2002, this remains beside the point. Grimes agrees with me that the BOJ was independent in the latter period. As far as the former is concerned, he quickly reverts to defining autonomy as the ability to set interest rates—thus agreeing with my view that the MOF had considerable influence over interest rates. My main argument that the BOJ had been acting autonomously concerning the more important quantity of credit remains unchallenged. Thus his claim that the BOJ was not independent remains without merit.

If Grimes wants examples of diverging policies of the ministry and the central bank between 1993 and 1998, he needs to look no further than the quantitative policy concerning foreign exchange transactions. With a few exceptions, the BOJ systematically sterilized MOF's foreign exchange intervention (often over-sterilizing), thus rendering them ineffective (a sign of lacking independence?). Finally, Grimes appears unaware that the MOF and Liberal Democratic Party (LDP) politicians have repeatedly, if sporadically, called for an increase in credit creation during the 1990s (not entirely without my input), but were always rebutted by the BOJ. I even found that when Governor Matsushita (a MOF alumnus who agreed with my articles about the need to increase the quantity of credit) attempted to order his staff to increase credit creation in 1996, he was fobbed off with technical jargon and excuses by the BOJ insiders.

Grimes wonders why Deputy Governor Mieno testified before the Diet that interest rates should be raised in 1987, but then lowered them the same year. There is no mystery here. MOF had legal and significant actual influence over interest rates. If Grimes wants to raise an interesting question, he should ask why the same Mieno at that time ordered his hand-picked successor Toshihiko Fukui (who was, during the speculative bubble years in charge of window guidance as director of the banking department, and who is today governor of the BOJ) to boost banks' loan growth quotas. This is interesting, because the literature agrees that MOF (or other players, for that matter) never influenced window guidance (partly because most observers believed the BOJ's protestations that credit controls had been abolished and, despite contrary empirical evidence, interest rates were the key tool).

As a political scientist, Grimes should consider the possibility of "political tactics" to explain Mieno's Diet testimony (to use Horiuchi's, 1993, expression concerning the BOJ's misleading representation of its actual monetary policy implementation), for instance to protest against the fact that MOF was to a large extent in charge of interest rates (or to place blame on MOF and create an alibi for himself). If Grimes was right and Mieno was sincerely worried about inflation or asset prices, why then did he force banks to increase their speculative lending? And why did he not publicly complain that window guidance should be tightened? The answer is that window guidance was not under the influence of MOF and thus Mieno had nothing to complain about (besides, he would have spilled the beans on his key policy tool). Which variable reveals the true intentions of the BOJ—public words, action of a tool that others influenced, or the deeds concerning a tool that it independently controlled?

Concerning Grimes' discussion of the so-called limited quantitative easing measures of March 2001, I should reiterate for sake of clarification that the economy is helped by neither the announced increases in the banks' deposits with the central bank (as they do not create credit) nor a gross increase in one type of purchase operation (if it is sterilized by other sales operations, as has frequently been the case). For instance, despite the rhetoric of the BOJ under its "new" governor, Fukui, since March 2003 that it will provide more liquidity to the economy, the reality has been a decline in its credit creation—increased bond purchases and record foreign exchange intervention ordered by MOF were over-sterilized by net sales of commercial paper (hence the rise of the yen during 2003, despite ¥20 trillion of tax money—funded by new debt—spent on intervention). Like the magician who draws attention to his right hand while performing his tricks with the left, the BOJ can still freely change its net credit creation, no matter what it promises about specific gross transactions, which are only part of the total.

The Goal of Monetary Policy

There is much evidence that both political leadership and the MOF have tried hard to stimulate the economy. The same cannot be said about the BOJ. Concerning its motivation, Grimes argues that instead of the aim to promote structural reform that I have identified, the most important goal was to avoid inflation—even if this constitutes "bad analysis" by the BOJ. But this logic is not compelling. If public prosecutors are faced with two possible motives for a crime, one of which is consistent and makes sense, while the other does not, they would discount the latter and work with the former until proven wrong. Likewise, economists are reluctant to assume irrationality as primary working hypothesis, as long as logically compelling explanations exist. The BOJ's revealed preference of keeping the quantity of credit tight is consistent with the motive frequently voiced throughout the 1990s by senior central bankers that they have been aiming at implementing structural change, for which, according to them, the recession has been useful. This argument of mine thus also remains unchallenged.

Grimes then argues that when the Bank of Japan talks about structural reform, it merely refers to avoiding the resurgence of asset inflation and the reduction of moral hazard. However, there is little evidence to back up this interpretation. Elsewhere, I have traced the structural reform argument to its authors, Fukui, Mieno, Maeakawa and Sasaki (all known as "princes" since their early thirties as they were selected to become first deputy governor, then governor; see Werner 2001, 2003b). All of them have given detailed descriptions of what they mean by "structural reform" or "transformation," namely to change Japan's entire economic system, to deregulate, liberalize, privatize and, in brief, abolish the post-war Japanese-style welfare capitalism (to borrow Ronald Dore's phrase). Instead, the central bankers wish to introduce what Dore calls U.S.-style stock market capitalism. Grimes just needs to check the op-ed pieces contributed by Toshihiko Fukui to the *Nikkei shimbun*, or Fukui's earlier interviews with the press, in which he has re-iterated his case for scrapping Japan's entire post-war economic structure.[6] None of these views are sudden inspirations but long-standing and well-documented convictions. My conclusion on this count is also seconded by others, such as Posen (2000). The argument of "intentionally dangerous policy" has not been refuted.

Concerning the policy option to solve the bad debt problem costlessly by having the Bank of Japan purchase all bad debts at face value, Grimes claims that the "moral hazard" argument put forward by the BOJ deserves serious attention. Again, Grimes fails to engage my findings and merely restates the BOJ case. For the record, the BOJ's moral hazard argument is hardly useful in this context because (a) the timing of worrying about moral hazard (i.e., excess bank lending) is inappropriate (those who worry about such moral hazard today should instead have done so in 1986, 1987, 1988 or 1989, when it was relevant, but they did not; bank credit growth has been falling, not booming, since the early 1990s); and (b) the moral hazard argument implies that "those who mess up must pay up" and hence its proper application requires an identification of responsibility and appropriate allocation of costs. Grimes suggests tax-funded programs to solve the bad debt problem, with punishment for bank management. However, it is precisely his, and the BOJ's, eagerness to saddle the Japanese taxpayers with yet more debt that creates enormous moral hazard. While Grimes suggests that taxpayers should foot the bill for the banks' bad debts, he shows no evidence that taxpayers (or even bank managers) were ultimately responsible for the accumulation of the bad debts. My research, on the other hand, demonstrates that the BOJ, through its window guidance credit expansion program was responsible for them. The two individuals carrying most responsibility were not punished, but elevated to the position of governor. This has created moral hazard, as BOJ insiders must conclude that they can get away with murder. If we wish to avoid moral hazard, it is the BOJ that must shoulder the costs of the clean-up, not taxpayers or other parties. (But since buying the bad debts would cost the BOJ nothing and would even yield a decent return, other measures to avoid moral hazard would still be required, such as the reduction in the excessive autonomy of the central bank and a parliamentary inquiry to call those responsible to account.) Grimes's assertion that "the BOJ does seem to take this [moral hazard] problem seriously" remains unsubstantiated. So far the BOJ has neither purchased the bad debts from the banks, nor punished those responsible for them. Thus it has not taken the moral hazard problem seriously (presumably since it is reluctant to punish itself).

Finally, Grimes argues that the purchase of nonperforming loans by the BOJ would be inadvisable, because it "would put the Bank [of Japan] in the political position of choosing which ones to roll over or to bring to bankruptcy court." This, he argues, would not be appealing to the central bank, because "it would draw the BOJ into a political arena where its autonomy in virtually every function would be threatened." Grimes should be reminded that central banks engage daily in what amount to political decisions about which companies receive funding and which do not. An obvious example is the conventional central bank policy to rediscount bills of exchange, whereby the central bank discriminates between companies. An institution which creates and allocates purchasing power, which determines economic growth and the business cycle, while influencing exchange rates and level of employment, cannot be considered as being outside the spectrum of political analysis. Central banks are political actors. I would expect that Grimes, as an astute political scientist, would not easily fall for the frequently propagated claim by central bankers that they are apolitical technocrats without vested interests and incapable of biases. Most recently, Joseph Stiglitz (2003) has argued that "central banks make decisions that affect every aspect of society, including rates of economic growth and unemployment. Because there are trade-offs, these decisions can only be made as part of a political process." It is surprising to find political scientists who see it otherwise.

In Closing

Grimes has provided no empirical or logical reasons why he remains unconvinced by my arguments. Could this have anything to do with the fact that his book on Japanese monetary policy (Grimes, 2001) only considers interest rate policy, and hence merely relates the BOJ's official "story"? It seems he is already hedging his bets by adopting my arguments. The new introduction to his paperback version (Grimes, 2002), incorporates many of the points I made in the draft of my article and my subsequent comments on his draft review (available to him since early 2002; my earlier papers publicizing my argument have been available since the first half of the 1990s). Grimes now writes: "Growing out of the BOJ's much-strengthened position in macroeconomic policy making has been its increasing involvement in matters that are not strictly related to monetary policy. The governor and other leaders in recent years have stated publicly that deflation can actually be beneficial to the economy as a means of forcing structural reform. This analysis, which goes directly against the current consensus among economists, takes monetary policy well beyond the BOJ's mandated task of maintaining stable prices and into the microeconomic or structural realm. In addition to this striking justification for avoiding quantitative easing as a tool of monetary policy, BOJ leaders have consciously—and often publicly—used monetary policy as a bargaining tool to try to force the government to follow through on fiscal and regulatory reforms" (p. xi).

I am happy that Grimes is following my research lead on this topic and his tone here suggests that he is, after all, convinced. Of course, I would have much preferred if in connection to this section he had made reference to any of my numerous works on the topic, not least my article he was entrusted with as discussant.

Yet, it is his attempt to reconcile the main thrust of his book (that monetary policy was significantly influenced by the MOF) with my argument, which fails to convince. Since he now seems to agree that what I say is true, but only for the period since 1998, he must demonstrate why it did not hold true in the period before. His argument hangs on the thread that before the law change the BOJ was not an interested party that pursued its own agenda (including to change the BOJ law itself!), but it suddenly turned into such an institution at the turn of a dime in 1998 (with the law change presumably not having been due to its lobbying and manipulations, but a gift from benevolent rival interest groups). In fact, the change of the BOJ law and dismantling of MOF were explicit goals of the BOJ's policy to trigger reform through recession. Further, if Grimes now agrees that the quantity of credit is key, why did his book not concern itself with this? The words "window guidance" or "credit creation," crucial to understand what happened in Japan during the 1980s and 1990s, do not appear in the index and this does not seem to be due to the index being faulty. And how do we know whether the MOF influenced the quantitative credit policy before 1998, if his book does not deal with the issue? If Grimes studied who decided the quantity of credit, I think he would quickly agree, rather like many researchers, that this was not a topic to which the MOF devoted much of its resources.

Despite all this, Grimes still argues that "The emergence of the BOJ as a powerful and public force for transforming the Japanese economy would have been inconceivable well into the 1990s" (p. xi). Evidently so to Grimes, but I have shown in my published work since the early 1990s that the BOJ had been precisely that—a powerful and long-established force for transforming the Japanese economy (see almost any of my already cited works, but especially Werner 1996a, 1996b, 1996c). Did I foresee the unforeseeable? By no means. Empirical research on the question of who determines the quantity of credit quickly led me to the answers.[7] Since 1992, I have verified in a number of publications that the variable important for nominal GDP growth is the quantity of credit, and, with bank credit not recovering, the quantity of central bank credit. Since then I have also criticized the BOJ for continuing to use window guidance as its main policy tool in the 1980s. Some of my work has been widely cited (*Economist*, 1993) or is well-1980s. Some of my work has been widely cited (*Economist*, 1993) or is well-known in Japan (see the bibliography of my article). It is unfortunate that Mr. Grimes appears to have been unaware of all this literature. But withholding it from his readers should not be the answer.

I hope we can now expect that Grimes' talent will be reoriented toward work on the long-standing gap between BOJ stories for public consumption and the reality of its actions, as well as the implications for Japan's political economy and democracy.[8] In recent publications, I have examined the phenomenon that the BOJ even succeeded in getting the alleged radical reformer Koizumi (he of "no sacred cows" fame) to appoint the most conservative, most vested of vested-interest candidates as governor of the BOJ—Toshihiko Fukui (Werner, 2003c). It is a stark illustration of the extent of the power wielded by the BOJ "princes" and their ability to implement long-term plans (something Grimes seems to doubt). It was of course not Koizumi who selected Fukui for the top job at the BOJ. That had been done thirty-four years earlier, by then-governor Tadashi Sasaki. Since then, "prince" Fukui had been known as the person who would be governor of the BOJ at the turn of the millennium. Such a phenomenon should attract the attention of any self-respecting political scientist. Perhaps collaborative work on this interesting topic is called for.

Notes

1. Instead, Grimes asks for my assessment of Kuttner and Posen (2001) who argue that fiscal policy has been stimulatory. Their finding remains the exception, as others, such as Bayoumi (2000), Perri (2001) and Ramaswamy and Rendu (2000) found that fiscal policy had little or even negative effect on growth during the 1990s (I predicted as early as 1994 and 1995 that fiscal policy would not be effective in creating a recovery; Werner 1994, 1995a, b, 1996a, b, c). While this is not the place for a discussion of Kuttner and Posen (2001), it suffices to say that among possible explanations for their finding is their use of annual budget data (consolidating from the various regional and central budgets), the exclusion of interest payments (by now substantial) and unemployment benefits from their definition of fiscal expenditure, or their omission of monetary policy.

2. Grimes agrees that since 1999 "the case for quantitative easing became increasingly clear to outside observers," but fails to explain why this case had not become clear to such observers in the early 1990s, when I already published my model and argued that neither interest rate reductions nor fiscal stimuli would help Japan's economy, as expanded credit creation was necessary and sufficient for growth. Grimes does not find it curious why observers continued to cling to models that had little basis in empirical evidence—a topic of interest to a political scientist. It may be pertinent that the interested party with the largest number of economists on its payroll, the Bank of Japan (BOJ), actively encouraged their use.

3. This argument has just been endorsed by the BIS, of which the BOJ is a shareholder, in its 2003 Annual Report.

4. In the real world central banks tend to have mastery over the quantity of credit they create, as they rarely receive orders concerning the net sum of purchase or sales operations they conduct. Friedman (1982) provides a readable and illuminating summary of decades of research on central bank transactions and de facto autonomy in the case of the U.S. Federal Reserve (also a central bank not enjoying strong legal independence) that Grimes might wish to consult.

5. As econometric studies have shown (Werner 1997, and my article), interest rates were not relevant in explaining economic growth, but the quantity of credit was. Grimes argues that the Bank of Japan has a history of being constrained in its ability to produce an autonomous monetary policy, but he does not demonstrate this to be true in any meaningful way. By contrast, I have shown that the BOJ has a history of not being constrained in its ability to produce an autonomous monetary policy, via its quantitative control. This is also what other researchers have found concerning earlier periods (Horiuchi 1993). To his credit, Grimes does not attempt to demonstrate Ministry of Finance (MOF) influence over credit creation by arguing that MOF controls the government banks. Since these don't create credit, this argument would have been a nonstarter.

6. Fukui (2002) calls for the "revision of the seniority-based promotion and lifetime employment systems," the unwinding of cross-shareholdings, increased borrowing from capital markets as opposed to bank funding, a shift of savings from deposits into "risk-assets," and the "inevitable move" of "drastically reducing or abolishing postal savings," to name but a few. In other publications, Fukui even ventures into such sectors as education, where he demands privatization, and so forth. All these echo the Maekawa and Sasaki

reports (the former partly authored by Mieno), which in turn echo long-standing demands by U.S. trade negotiators in their attempts to improve the U.S. competitive position vis-à-vis Japan.

7. Some BOJ staff had told me as early as 1993, when I pressed them as to why they did not increase credit creation despite a widening shrinkage in bank credit, that an expansion in central bank credit would create a recovery, but would also mean that Japan's economic structure would not change. At the time I could not yet quite believe that the BOJ would purposely prolong the recession to achieve its political goals, but subsequent overwhelming empirical evidence convinced me otherwise.

8. In this context, Grimes's new preface refers to the central bank reform group of the Liberal Democratic Party (LDP), as I do in some of my publications. This group was founded upon the instigation of Professor Yoichi Masuzoe, a known TV moderator and former political science professor at Tokyo University, who, upon reading my book *Princes of the Yen* in June 2001, made the election promise to try to implement my recommendation therein to change the BOJ law to render the central bank accountable. He won as the Upper House candidate with the most votes and lived up to his promise. However, so far the BOJ, partly due to its influence on the financial press, has remained the superior political actor, thus blunting this initiative.

References

Bayoumi, Tamim. 2000. "The Morning After: Explaining the Slowdown in Japanese Growth in the 1990s." In *Post-Bubble Blues, How Japan Responded to Asset Price Collapse*, ed. Tamim Bayoumi and Charles Collyns. Washington, DC: International Monetary Fund.

Economist. 1993. "A Japanese Puzzle," Economics Focus, June 13, 1993.

Friedman, Milton. 1982. "Monetary Policy, Theory and Practice." *Journal of Money, Credit, and Banking* 14, no. 1 (February): 98–118.

Fukui, Toshihiko. 2002. "Capitalist Model Faces Stiff Challenge." *Nikkei Weekly* (December 23), p. 7.

Grimes, William W. 2001. *Unmaking the Japanese Miracle, Macroeconomic Politics, 1985–2000*. Ithaca and London: Cornell University Press.

——. 2002. *Unmaking the Japanese Miracle, Macroeconomic Politics, 1985–2000, With a New Preface*. Ithaca and London: Cornell University Press (paperback edition).

Horiuchi, Akiyoshi. 1993. "Monetary Policies: Japan." In *The Politics of Economic Change in Postwar Japan and West Germany*, vol. 1, ed. Haruhiro Fukui, Peter H. Merkl, Hubertus Mueller-Groeling, and Akio Watanabe. London: Macmillan Press.

Krugman, Paul. 1998. "It's Baaack: Japan's Slump and the Return of the Liquidity Trap." *Brookings Papers on Economic Activity*, no. 2: 137–205.

Kure, Bunji. 1973. *Kinyuu seisaku—Nihon ginkou no seisaku unei*. Tokyo: Toyo keizai shinposha.

Kuttner, Kenneth, and Adam Posen. 2002. "Fiscal Policy Effectiveness in Japan." *Journal of the Japanese and International Economies* 16, no. 4 (December): 536–58.

Okazaki, Tetsuji. 2002. "1980 nendai no ginkou keiei—senryaku, soshiki, gabanansu." In *Heisei Baburu no Kenkyuu, Baburu no hassei to sono haikeikouzou*, ed. Muramatsu Michio and Masahiro Okuno. Tokyo: Toyo keizai shinposha.

Patrick, Hugh. 1962. *Monetary Policy and Central Banking in Japan*. Bombay: University of Bombay Press.

Perri, Fabrizio. 2001. "The Role of Fiscal Policy in Japan: A Quantitative Study." *Japan and the World Economy* 13, no. 4: 387–404.

Posen, Adam S. 2000. "The Political Economy of Deflationary Monetary Policy." In *Japan's Financial Crisis and Its Parallels to U.S. Experience*, ed. Ryoichi Mikitani and Adam S. Posen. Washington, DC: Institute for International Economics, Special Report 13 (September).

Ramaswamy, Ramana, and Christel Rendu. 2000. "Identifying the Shocks: Japan's Economic Performance in the 1990s." In *Post-Bubble Blues, How Japan Responded to Asset Price Collapse*, ed. Tamim Bayoumi and Charles Collyns. Washington, DC: International Monetary Fund.

Stiglitz, Joseph E. 2003. "Big Lies About Central Banks." *The Daily Yomiuri*, June 7, 2003.

Werner, Richard A. 1991. "The Great Yen Illusion: Japanese Foreign Investment and the Role of Land-Related Credit Creation." Oxford Institute of Economics and Statistics Applied Economics Discussion Paper, No. 129. Oxford: Oxford Institute of Economics and Statistics (December).

——. 1992. "Towards a Quantity Theorem of Disaggregated Credit and International Capital Flows." Paper presented at the Royal Economic Society annual conference, York, April 1993.

——. 1994. *Liquidity Watch*, May edition. Tokyo: Jardine Fleming Securities.

——. 1995a. "Bank of Japan: Start the Presses!" *Asian Wall Street Journal*, June 13.

——. 1995b. "Keiki kaifuku, ryōuteki kin'yū kanwa kara." *Nihon keizai shinbun*. Keizai kyōushitsu, September 2.

——. 1996a. "The BOJ Prolonged Japan's Recession." *Asian Wall Street Journal*, June 13.

——. 1996b. "Nichigin Manipulation." *Ronsō tōyō keizai*, Part I (July): 64–73; Part II (September): 130–39; Part III (November): 190–95.

——. 1996c. "How the Bank of Japan Won." *Asian Wall Street Journal*, November 11.

——. 1997. "Towards a New Monetary Paradigm: A Quantity Theorem of Disaggregated Credit, with Empirical Evidence from Japan." *Kredit und Kapital* 30, no. 2 (July).

——. 1998. "Bank of Japan Window Guidance and the Creation of the 'Bubble.'" In *El Japon Contemporaneo*, ed. Florentino Rodao and Antonio Lopez Santos. Salamanca: University of Salamanca Press.

——.1999a. "Nihon ni okeru madoguchi shidō to 'bubble' no keisei." *Gendai Finance*, MPT Forum (March), pp. 17–40.

——. 1999b. "Baburu no youin wo tsukuttanowa nichigin no madoguchishidou data." *Shuukan Economist*, April 13.

——. 2001. *En no Shihaisha* (Princes of the Yen). Tokyo: Soshisha.

——. 2002. "Monetary Policy Implementation in Japan: What They Say Versus What They Do." *Asian Economic Journal* 16, no. 2 (June): 111–51.

——. 2003a. *Towards a New Macro-economic Paradigm, Solving the Puzzle of Japanese Economic Performance in the 1980s and 1990s*. Tokyo: PHP Institute Press (in Japanese; English edition forthcoming in 2004).

——. 2003b. *Princes of the Yen, Japan's Central Bankers and the Transformation of the Economy*. Armonk, NY: M.E. Sharpe.

——. 2003c. *Central Banking and Structural Change*. Tokyo: Soshisha (in Japanese).