Central banks 'experimenting' to counter deflationary pressure

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Second of two parts

A major challenge for Japan at present is to find ways to counter the deflationary pressure arising from further rises of the yen's exchange rate, not only against the U.S. dollar itself but also against the currencies of China and other emerging Asian and Latin American economies that manage their exchange rates against the U.S. dollar.

We must of course first note that the decline in Japan's export volume, at an annual rate of some 55 percent between the third quarter of 2008 and the first quarter of this year, occurred against the background of global export market contraction. However, according to an estimate by the Organization for Economic Cooperation and Development (OECD), the decline in the size of Japan's export market for this year is 16.6 percent, not much different from the OECD area average of 15.4 percent.

The second factor contributing to the dramatic decline in Japan's exports is their composition, which is heavily concentrated on automobiles, information technology and other sophisticated capital goods. Inventories of such products were squeezed more rapidly than those of other goods in Japan's export markets by the global financial crisis. But countries such as Germany, whose exports have somewhat similar compositions, have not suffered as severely as Japan.

The third factor is the Japanese yen's sharp rise since 2007. The rise of the yen between 2007 and 2009, based on the assumption that exchange rates for the second half of this year will remain at mid-2009 levels, amounts to 18.9 percent against the U.S. dollar and to

25.1 percent in effective terms. The yen's advance being sharper in effective terms than against the U.S. dollar reflects the decline of the currencies of the United Kingdom, Korea and emerging economies in Asia and Latin America over this period as a whole. On top of this, the yen has advanced further in recent weeks.

These currency movements will exert unwelcome deflationary pressure on the Japanese economy, basically through four channels: (1) Weaker export demand will widen the output gap; (2) a further decline in import prices will accelerate consumer price deflation; (3) international cost comparisons against Japan will encourage a further shift of production bases abroad by Japanese producers, aggravating business fixed investment and reducing employment at home; and (4) those firms maintaining production bases at home will be forced to cut wages and other costs even more to cope with a further loss of international price competitiveness associated with the yen's sharper rise.

Lower consumer prices will moderate the decline in real wages relative to nominal wages. Nevertheless, real wage cuts together with reduced employment will lower household income and consumption in real terms in a situation where Japan's personal savings rate has already fallen to about 3 percent, somewhat lower than current U.S. and U.K. levels and far below Germany's.

With a zero bound on nominal interest rates, intensified deflation will further increase real interest rates and weaken credit demand even more, thus entailing a deflation spiral. How does the Bank of Japan (BOJ) intend to deal with this difficult situation?

No clue can be found in the bank's half-year monetary policy report published in April, in subsequent public statements and speeches by its governor and other senior officials, or in any other published materials. Lack of information about how the BOJ will deal with further upward pressure on the yen appears to have weakened central bank credibility and increased market uncertainty and volatility.

At a time when the Japanese economy suffered from the combination of the burst of its self-made bubble and the concomitant upward pressure on the yen in the 1990s, professor Allan Melzer of Carnegie Mellon

University and other American economists proposed that the BOJ expand the monetary base to put downward pressure on the yen. Indeed, Japan's monetary base expanded sharply, but the yen's weakening was not sustained. A reason for this given by professor Melzer was an intervention by a then-senior U.S. Treasury official to stop adjustment of the yen.

In the context of dealing with the current financial crisis, the Bank of England has adopted a policy of expanding the monetary base to increase nominal demand and to ensure that inflation moves toward the target level. At the same time, the bank reduced its policy rate very aggressively, so that it is not clear whether the bank's policy of "quantitative easing" has helped to drive down the U.K. pound, or if so, by how much.

Another interesting experiment has been tried by Canada. In its monetary policy report published in July, the Bank of Canada stated "a stronger and more volatile Canadian dollar could act as a significant drag on growth and put additional downward pressure on inflation for Canada," thus indicating the level beyond which the bank does not like to see the Canadian dollar rise.

Note that this statement was made at a time when the Canadian dollar was fairly stable — C$1 equaled about $0.80, some 20 percent lower than the level prevailing a year earlier. The statement was preceded by the Bank of Canada's decision, announced last April, to make a conditional commitment to hold the central bank policy rate at 0.25 percent until the second quarter of 2010.

In the monetary policy report published in that month, the bank outlined a framework describing unconventional measures it could employ, if needed, and principles that would govern the use of those tools. This policy framework of the Bank of Canada is far more transparent and more helpful in providing information about the future course of its monetary policy than that actually in use by the BOJ.

A third interesting experiment is found in Sweden. In July, its central bank lowered the interest rate on its one-week deposit facility to negative 0.25 percent at the same time that it squeezed its benchmark lending rate down to 0.25 percent. The actual amount left in that account appears to be far smaller than the overnight deposit facility, on which it pays a 0.15 percent interest rate. Nevertheless, the Swedish central bank has embraced a policy that the BOJ could use to deal with deflationary pressure.

This brief review of experiments by some central banks abroad suggests that the BOJ could use a greater variety of unconventional policy instruments than are currently in use in Japan in a situation where its policy rate is as low as 0.1 percent (the current rate). The bank must adopt a more aggressive policy stance in warding off deflation.

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