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By Richard Duncan

[What keeps the US and the world economy afloat at a time when US balance of payments and budget deficits have soared to unprecedented levels? As The Economist noted in its September 23, 1999 edition, "Never before in history have central banks wielded so much power." That power has only increased, as central governments continue to withdraw from economic management by reducing redistributive taxes, transfers and regulations, thus leaving even more decisions to central banks, the market and lower levels of the state. As central bankers become more influential, it is reasonable to ask what lies behind their decisionmaking and how they might be held more accountable. The long series of asset bubbles over the past decade suggests that there is something fundamentally wrong in the governance of the financial side of the economy.

This is the context for Richard Duncan's analysis of the strategy of Japanese and Chinese central banks in underwriting US deficits. Duncan takes no position on the larger debate over central bank governance, but instead offers a fascinating, speculative glimpse into their decisionmaking processes. Duncan asks whether it is possible that central bankers in Japan and America made a political decision to coordinate their policies. Duncan concludes that central bankers stopped a spiral into deflation. From another perspective, however, unelected officials propped up the fiscal irresponsibility of the Bush regime as well as poured more froth on the worsening bubble-trouble hangover from the 1990s. Japan Focus]

In 2003 and the first quarter of 2004, Japan carried out a remarkable experiment in monetary policy, remarkable in the impact it had on the global economy and equally remarkable in that it went almost entirely unnoticed in the financial press. Over those 15 months, monetary authorities in Japan created ¥35 trillion. To put that into perspective, ¥35 trillion is approximately 1% of the world's annual economic output. It is roughly the size of Japan's

annual tax revenue base or nearly as large as the loan book of UFJ, one of Japan's four largest banks. ¥35 trillion amounts to the equivalent of \$2,500 for every person in Japan and, in fact, would amount to \$50 per person if distributed equally among the entire population of the planet. In short, it was money creation on a scale never before attempted during peacetime.

Why did this occur? There is no shortage of yen in Japan. The yield on two year JGBs is 10 basis points. Overnight money is free. Japanese banks have far more deposits than there is demand for loans, which forces them to invest up to a quarter of their deposits in low yielding government bonds. So, what motivated the Bank of Japan to print so much more money when the country is already flooded with excess liquidity?

The Bank of Japan gave the ¥35 trillion to the Japanese Ministry of Finance in exchange for MOF debt with virtually no yield; and the MOF used the money to buy approximately \$320 billion from the private sector. The MOF then invested those dollars into US dollar-denominated debt instruments such as government bonds and agency debt in order to earn a return.

The MOF bought more dollars through currency intervention then than during the preceding 10 years combined, and yet the yen rose by 11% over that period. Historically, foreign exchange

intervention to control the level of a currency has met with mixed success, at best; and past attempts by the MOF to stop the appreciation of the yen have not always succeeded. They were very considerably less expensive, however. It is also interesting, and perhaps important, to note that the MOF stopped intervening in March 2004 just when the yen was peaking; that the yen depreciated immediately after the intervention stopped; and that when the yen began appreciating again in October 2004, the MOF refrained from further intervention.

So, what happened in 2003 that prompted the Japanese monetary authorities to create so much paper money and hurl it into the foreign exchange markets? Two scenarios will be explored over the following paragraphs.

In 2002, the United States faced the threat of deflation for the first time since the Great Depression. Growing trade imbalances and a surge in the global money supply had contributed to the credit excesses of the late 1990s and resulted in the New Paradigm technology bubble. That bubble popped in 2000 and was followed by a serious global economic slowdown in 2001. Policy makers in the United States grew increasingly alarmed that deflation, which had taken hold in Japan, China and Taiwan, would soon spread to America.

Deflation is a central bank's worst nightmare.

When prices begin to fall, interest rates follow them down. Once interest rates fall to zero, as is the case in Japan at present, central banks become powerless to provide any further stimulus to the economy through conventional means and monetary policy becomes powerless. The extent of the US Federal Reserve's concern over the threat of deflation is demonstrated in Fed staff research papers and the speeches delivered by Fed governors at that time. For example, in June 2002, the Board of Governors of the Federal Reserve System published a Discussion Paper entitled, "Preventing Deflation: Lessons from Japan's Experience in the 1990s." The abstract of that paper concluded "...we draw the general lesson from Japan's experience that when inflation and interest rates have fallen close to zero, and the risk of deflation is high, stimulus-both monetary and fiscal- should go beyond the levels conventionally implied by baseline forecasts of future inflation and economic activity."

From the perspective of mid-2002, the question confronting those in charge of preventing deflation must have been how far beyond the conventional levels implied by the base case could the economic policy response go? The government budget had already swung back into a large deficit and the Federal Funds rate was at a 41 year low. How much additional stimulus could be provided? A further increase in the budget deficit seemed likely to push up market

determined interest rates, causing mortgage rates to rise and property prices to fall, which would have reduced aggregate demand that much more. And, with the Federal Funds rate at 1.75% in mid- 2002, there was limited scope left to lower it further. Moreover, given the already very low level of interest rates, there was reason to doubt that a further rate reduction would make any difference anyway.

In a speech entitled, "Deflation: Making Sure 'It' Doesn't Happen Here", delivered on November 21, 2002, Federal Reserve Governor Ben Bernanke explained to the world exactly how far beyond conventional levels the policy response could go. Governor Bernanke explained that the Fed would not be "out of ammunition" just because the Federal Funds rate fell to 0% because the Fed could create money and buy bonds of longer maturity in order to drive down yields at the long end of the yield curve as well. Moreover, he said, "In practice, the effectiveness of anti-deflation policy could be significantly enhanced by cooperation between the monetary and fiscal authorities. A broad-based tax cut, for example, accommodated by a program of open-market purchases to alleviate any tendency for interest rates to increase, would almost certainly be an effective stimulant to consumption and hence to prices."

He made similar remarks in Japan in May 2003 in a speech entitled, "Some Thoughts on Monetary

Policy in Japan". He said, "My thesis here is that cooperation between the monetary and fiscal authorities in Japan could help solve the problems that each policymaker faces on its own. Consider for example a tax cut for households and businesses that is explicitly coupled with incremental BOJ purchases of government debt—so that the tax cut is in effect financed by money creation." These speeches attracted tremendous attention and for some time financial markets believed the Fed intended to implement the "unorthodox" or "unconventional" monetary policy options Governor Bernanke had outlined.

In the end, the Fed did not resort to unorthodox measures. The Fed did not create money to finance a broad-based tax cut in the United States. The Bank of Japan did, however. Three large tax cuts took the US budget from a surplus of \$127 billion in 2001 to a deficit of \$413 billion in 2004. In the 15 months ended March 2004, the BOJ created ¥35 trillion which the MOF used to buy \$320 billion, an amount large enough to fund 77% of the US budget deficit in the fiscal year ending September 30, 2004. It is not certain how much of the \$320 billion the MOF did invest into US Treasury bonds, but judging by their past behavior it is fair to assume that it was the vast majority of that amount.

Was the BOJ/MOF conducting Governor Bernanke's Unorthodox Monetary Policy on behalf of the Fed? There is no question that the

BOJ created money on a very large scale as the Fed would have been required to do under Bernanke's scheme. Nor can there be any question that the money created was used to buy an increasing supply of US Treasury bonds being issued to finance the kind of broad-based tax cuts Governor Bernanke had discussed. Moreover, was it merely a coincidence that the really large scale BOJ/MOF intervention began during May 2003, while Governor Bernanke was visiting Japan? Was the BOJ simply serving as a branch of the Fed, as The Federal Reserve Bank of Tokyo, if you will? This is Scenario One.

If this was globally coordinated monetary policy (unorthodox or otherwise) it worked beautifully. The Bush tax cuts and the BOJ money creation that helped finance them at very low interest rates were the two most important elements driving the strong global economic expansion during 2003 and 2004. Combined, they produced a very powerful global reflation. The process seems to have worked in the following way:

US tax cuts and low interest rates fuelled consumption in the United States. In turn, growing US consumption shifted Asia's export-oriented economies into overdrive. China played a very important part in that process. With a trade surplus vis-à-vis the United States of \$124 billion, equivalent to 9% of its GDP in 2003 (rising to approximately \$160 billion or above 12% of GDP in 2004), China became a regional

engine of economic growth in its own right. China used its large trade surpluses with the US to pay for its large trade deficits with most of its Asian neighbors, including Japan. The recycling of China's US Dollar export earnings explains the incredibly rapid "reflation" that began across Asia in 2003 and that was still underway at the end of 2004. Even Japan's moribund economy began to reflate.

Whatever its motivation, Japan was well rewarded for creating money and buying US Treasury bonds with it. Whereas the BOJ had failed to reflate the Japanese economy directly by expanding the domestic money supply, it appears to have succeeded in reflating it indirectly by expanding the global money supply through financing the sharp increase in the MOF's holdings of US Dollar foreign exchange reserves. There is no question as to if this happened. It did. The only question is was it planned (globally coordinated monetary policy) or did it simply occur by coincidence, driven by other considerations?

What other considerations could have prompted the BOJ to create ¥35 trillion over 15 months? A second scenario is that a "run on the dollar" forced the monetary authorities in Japan to intervene on that scale to prevent a balance of payments crisis in the United States. This is Scenario Two.

During the Strong Dollar Trend of the late 1990s, foreign investors, both private and public, invested heavily in the United States. Those investments put upward pressure on the dollar and on US asset prices, including stocks and bonds. The trend became self-reinforcing. The more capital that entered the US, the more the dollar and dollar denominated assets rose in value. The more those assets appreciated, the more foreign investors wanted to own them. Because of the large sums entering the country, the United States had no difficulty in financing its giant current account deficit, even though that deficit nearly tripled between 1997 and 2001.

By 2002, however, with the US current account deficit approaching 5% of US GDP, it became increasingly apparent that the Strong Dollar Trend was unsustainable. The magnitude of the current account deficit made a downward adjustment in the value of the dollar unavoidable. At that point, the Strong Dollar Trend gave way and the Weak Dollar Trend began. Foreign investors who had invested in US dollar denominated assets during the late 1990s naturally wanted to take their money back out of the United States once it became clear that a sharp correction of the dollar was underway. Moreover, many US investors, and hedge funds in particular, also began selling dollar-denominated assets and buying non-US dollar-denominated assets to profit from the dollar's decline.

The change in the direction of capital flows can be seen very clearly in the breakdown of Japan's balance of payments. Traditionally, Japan runs a large current account surplus and a slightly less large financial account deficit, with the difference between the two resulting in changes (usually additions) to the country's foreign exchange reserves.

Beginning in 2003, however, there was a startling change in the direction of the financial account. Instead of large financial outflows from Japan to the rest of the world, there were very large financial inflows. For instance, in May 2003, Japan's financial account reflected a net inflow of \$23 billion into the country. The net inflow in September was \$21 billion. These amounts increased considerably during the first quarter of 2004, averaging \$37 billion a month.

The capital inflows into Japan at that time were massive, even relative to Japan's traditionally large annual current account surpluses. But, why did Japan, which normally exported capital, suddenly experience net capital inflows on a very large scale in the first place? The most likely explanation is that very large amounts of private sector money began fleeing the dollar and seeking refuge in the relative safety of the yen.

When the Strong Dollar Trend broke, had the BOJ/MOF not bought the dollars that the private sector sold in such large quantities, the United

States would have faced a balance of payments crisis, in which, in addition to having to fund a half a trillion dollar a year trade deficit, it would have had to find a way to fund a deficit of several hundred billion on its financial account as well.

Any other country facing a large shortfall on its balance of payments would have experienced a reduction in its foreign exchange reserves. The United States, however, maintains only a limited amount of such reserves; only \$75 billion as at the end of 2003, far too little to fund the private capital outflows occurring at that time.

Once those reserves had been depleted, market-determined interest rates in the US would have begun to rise, in all probability, popping the US property bubble and throwing the country into recession. Under that scenario, a reduction in consumption in the United States would have undermined global aggregate demand and created a severe world-wide economic slump.

The US current account deficit more or less finances itself since the central banks of the surplus countries buy the dollars entering their countries to prevent their currencies from appreciating and then recycle those dollars back into US dollar-denominated assets in order to earn interest on them.

Large scale private sector capital flight out of dollars presented the recipients of that capital

with the same choice. The central bank of each country receiving the capital inflow had the choice of either printing their domestic currency and buying the incoming capital or else allowing their currency to appreciate as the private sector swapped out of dollars. The European Central Bank chose to allow the euro to appreciate. The Bank of Japan and the People's Bank of China chose to print yen and renminbe and accumulate the incoming dollars to prevent their currencies from rising. If some central bank had not stepped in and financed the private sector capital flight out of the dollar, then sharply higher US interest rates most likely would have thrown the world into a severe recession. It is quite likely that this consideration also played a role in influencing the actions of the Japanese monetary authorities during this episode.

The BOJ/MOF stopped intervening in March 2004. By that time, the Fed had indicated that it planned to begin tightening interest rates. That put a stop to the private sector capital flight out of the dollar. Therefore no more intervention was required. At the same time, by the end of the first quarter of 2004, it was becoming clear that strong economic growth in the US was creating higher than anticipated tax revenues. That meant a smaller than expected budget deficit. In July, the President's Office of Management and Budget revised down its estimate of the budget deficit from \$521 billion to \$445 billion. The actual deficit turned out to be \$413 billion. Thus less

funding was required than initially anticipated.

So, what did motivate the monetary authorities in Japan to create the equivalent of 1% of global GDP and lend it to the United States? Was it simply, straightforward self interest to prevent a very sharp surge in the value of the yen? Was it globally coordinated monetary policy designed to pull the world out of the 2001 slump and prevent deflation in the United States? Or, was it necessary to stave off a US balance of payments crisis that would have produced a global economic crisis?

Perhaps it was only straightforward foreign exchange intervention to prevent a crippling rise in the value of the yen. Intentionally or otherwise, however, by creating and lending the equivalent of \$320 billion to the United States, the Bank of Japan and the Japanese Ministry of Finance counteracted a private sector run on the dollar and, at the same time, financed the US tax cuts that reflatd the global economy, all this while holding US long bond yields down near historically low levels.

In 2004, the global economy grew at the fastest rate in 30 years. Money creation by the Bank of Japan on an unprecedented scale was perhaps the most important factor responsible for that growth. In fact, ¥35 trillion could have made the difference between global reflation and global deflation. How odd that it went unnoticed.

This is a slightly abbreviated version of an article that author of Dollar Crisis: Causes, Consequences, Cures. appeared in Finance Asia, February 2005. Posted at Japan Focus on May 19, 2005. <http://www.financeasia.com/>. Richard Duncan is the