**Lessons from the Recovery from the "Lost Decade" in Japan:
The Case of the Great Intervention and Money Injection**

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In the last three years, the Japanese economy has improved greatly compared to the decade-long period of near zero economic growth and deflation that began in the early 1990s. Once again Japanese economic growth is contributing to world economic growth as the expansion in Japan begins to set records for its durability.

What has been responsible for this recovery? The banking and other economic reforms of the Koizumi administration have been very important, and such reforms will need to be continued to sustain strong economic growth in the future. However, the key to the recovery, in my view, has been the quantitative easing of monetary policy that began in March 2001, but which really took off in 2003 and 2004 with substantial increases in the rate of growth of the monetary base. Since I had been of the view that a primary cause of the lost decade in Japan was a change in monetary policy, it is particularly gratifying to have seen these monetary injections and resulting economic recovery in these years.[1] No causal relationship can be proven beyond a shadow of a doubt in economics, however, and there are alternative explanations that will have to be sorted out over time. For example Masahiko Aoki makes the case for institutional

[1] See, for example, Taylor, John B. "Low Inflation, Deflation, and Policies for Future Price Stability," in *Monetary and Economic Studies*, Bank of Japan, February 2001.

changes and Ronald McKinnon focuses on exchange rate appreciation in the 1990s.[2] Regarding the exchange rate, CHART 1 shows that changes in the exchange rate were much smaller in the 1990s than in the years of high growth and economic stability in the 1970s and 1980s and are therefore unlikely to have been a primary source of the problems in the 1990s.

It was also during the 2003-2004 period that the Bank of Japan purchased large amounts of foreign exchange as it intervened in the exchange markets. An important question with lessons learned for the future is whether and how this "great intervention" was connected to the quantitative easing, the increase in the monetary base, and thereby to the ultimate recovery in Japan. Of course, as the economy is recovering and deflation is passing, the need for quantitative easing is receding and the Bank of Japan is rightly moving into a conventional monetary policy with the interest rate above zero in which the interest rate will be likely be set according to policy rules that have worked well at other central banks around the world. CHART 2, drawn from my 2001 paper as guidance for this phase of the recovery, illustrates the passage from the zero interest rate policy zone.

Nevertheless it is important to understand all aspects of policy during the quantitative easing period, and the main purpose of this paper is to further that understanding by reviewing the great intervention. I focus in particular on the exchange rate diplomacy between the United States and Japan during this period because there are important lessons to be learned from it. This diplomacy was motivated, at least on the U.S. side, by a desire to facilitate increases in the monetary base to end deflation. There

[2] See Aoki, Masahiko, 'Wither Japan's Corporate Governance," in the Afterward to *Corporate Governance in Japan: Institutional Change and Organizational Diversity* Oxford University Press, and Ronald McKinnon, *Exchange Rates Under the East Asian Dollar Standard*, MIT Press

are, of course, many lessons to be learned from the recovery from the lost decade, but the role of the massive exchange market interventions and massive increases in the monetary base must be at the top of the list.[3]

Some General Principles of Exchange Rate Policy in the United States

In order to explain the exchange rate diplomacy between the United States and Japan during this period it is first necessary to give my own perspective on overall U.S policy regarding exchange rates, at least as it applied during the period of the great intervention. In exchange rate policy, as in all areas of economic policy making, it is useful to work with certain basic principles. I will focus on several broad principles, again largely pertaining to the United States.

The most important principle is also the simplest—a good exchange rate policy must be supported by sound domestic economic policies. Monetary policy should focus on maintaining the purchasing power of the dollar; countries that let inflation get out of hand always suffer from unstable depreciating currencies. Fiscal policy, tax policy and regulatory policy are also viewed as important.

Second, policy makers in the United States have generally been relying on the markets to determine the exchange rate with a minimum of intervention, or direct buying and selling currency in the market, and they have communicated this policy as clearly as possible to the markets. However, it is also unwise to say dogmatically that you would never intervene. It is important to stress that he exchange rate is not

[3] A more detailed story about the policy development and operational implementation during this period is found in Chapter 10 of my forthcoming book, *Global Financial Warriors*. WW Norton, New York, 2007

considered a separate instrument of policy; rather it is the market's reflection of economic policy and a host of other factors.

Being cautious about government intervention in the foreign exchange markets does not imply that you should ignore developments in the exchange markets. A sharply depreciating exchange rate could reflect a lack of confidence in other policies. Moreover, even if the United States does not intervene other countries do, and this can affect the exchange rate.

Another principle generally followed in the United States in recent years is that government officials should minimize verbal intervention. The markets pay close attention to what senior government officials say about the exchange markets. In particular trying to "talk down the dollar," by saying, for example, it is overvalued is bad because it conjures up all the terrible policies that are associated with weak currencies, including an inflation prone monetary policy. Moreover, for verbal intervention to appear credible it must be backed up by action, at least occasionally, so verbal intervention leads to actual intervention. Many traders like officials to comment, and it is sometimes difficult not to comment. For finance officials who have responsibility for exchange rate policy it is especially difficult not to comment. By their nature, comments cause volatility, and for this reason, the United States has adopted a policy that the Treasury Secretary makes all comments about the dollar and that those comments are few and far between.

Of course, an exchange rate policy is not solely the decision of one country. The exchange rate between the dollar and the yen depends not only on whether the United States decides to follow the principles that I just outlined, but also on whether Japan decides to follow those principles. A fourth principle, therefore, is the need for an exchange rate diplomacy strategy. If the United States thinks Japan or any other country should stop intervening, then it must develop a diplomatic strategy to bring this change about. As with all diplomatic strategies one has to determine whether bilateral or multilateral approaches will work, whether a new coalition is needed, or whether an international institution like the International Monetary Fund should be brought into play.

Finally, policy makers must recognize that the exchange rate influences international political and security issues and therefore need to develop an interagency process for systematically addressing these other concerns. A good exchange rate policy requires reaching a delicate balance between the three separate forces of finance, politics, and security. It is no surprise then, that in the United States, the White House and the National Security Council are interested in exchange rate policy.

In the United States and Japan, the central bank and the finance ministry divide responsibility on monetary matters. The central bank has responsibility for domestic monetary policy, which primarily concerns setting the short term interest rate or the money supply. The finance ministry has responsibility for exchange rate policy, which includes decisions about intervention in the foreign exchange market and decisions about whether to engage with other countries about their intervention.

As with all policy matters, exchange rate decisions may or may not travel all the way up the financial chain of command to the President or the Prime Minister. In my experience, designing an overall diplomatic strategy to deal with countries like Japan or

China on their exchange rate policy would definitely be something that the President would be involved in.

With the creation of the Euro, governance of exchange rate policy in Europe has become more complex. While the European Central Bank sets the interest rate, it shares responsibility for the exchange rate with the group of finance ministers in the Euro Group. Hence, the ECB has more responsibility for the exchange rate than the Fed or the Bank of Japan.

The Great Intervention and the End of the Lost Decade

Deciding on a strategy for dealing with the Japanese intervention in the markets was one of the first diplomatic issues the Bush Administration faced in the currency area. (A China strategy came later). Economic growth in Japan had hovered near zero for much of the 1990s, which is why many called it the "lost decade." Japan was experiencing a deflation which was holding back economic growth because consumers and businesses curtailed their spending plans, anticipating lower prices in the future. The deflation and lack of growth made it difficult for people to pay interest on, or even pay back, their bank loans. Hence, the banks found themselves with many non-performing loans, on which payments were not being made, a clear threat to the banks and the whole banking system.

Economic stagnation in Japan was clearly not in the best interests of the United States. A stronger Japanese economy would provide the resources to help Japan play a key role with the United States and other allies in providing security and development assistance to poor countries. Two developments presented an opportunity for the United States to help Japan change direction.

First, in March 2001, the Bank of Japan announced that it would follow the new type of monetary policy, which it called "quantitative easing" and under which it would pump up the money supply in Japan until the deflation ended. I was ecstatic when I heard this announcement. Since 1994 I had been an adviser to the Bank of Japan, a position I had to resign from when I joined the Bush Administration and I had recommended many times that the Bank of Japan focus on increasing the money supply as a means to end their deflation, and many other economists had recommended the same thing.

Second, in April 2001, Junichiro Koizumi was elected Prime Minister in Japan. When President Bush met with Prime Minister Koizumi at Camp David in June 2001, he strongly supported the Prime Minister's reforms, saying to the press afterwards, "I have no reservations about the economic reform agenda that the Prime Minister is advancing. He talks about tackling difficult issues that some leaders in the past refused to address." Their friendship and mutual respect--which set the tone for discussions at all levels--was symbolized by the frequent reference by the Prime Minister to his favorite movie, High Noon, and how it reminded him of President Bush's determination and leadership. They discussed the economic issues too – including the problem in the Japanese banking system. In this way President Bush and his team developed a new approach to U.S. economic relations with Japan.

The U.S. policy toward exchange rate intervention in Japan starting at the end of 2002 was part of an effort to be supportive of quantitative easing which was in turn part of this broader economic engagement. By not registering objections to the intervention, effectively allowing it to happen, the U.S. might make it easier for Japan to pump up their money supply. The strategy was to work this way: When the Bank of Japan intervenes and buys dollars in the currency markets at the instruction of the Finance Ministry, it pays for the dollars with yen. For every 10 billion of U.S. dollars they purchase, they pay out over a trillion yen; in other words they increase the Japanese money supply by over a trillion yen. Unless the Bank of Japan offsets—sterilizes is the technical term—this increase in yen by buying other assets, such as Japanese government bonds, the Japanese money supply increases. In the past, U.S. Administrations had leaned heavily against the Japanese intervening in the markets to drive down the yen. By adopting a more tolerant position toward intervention—especially if it went unsterilized—the U.S. could help to increase the money supply in Japan.

After a few months into 2003, the unprecedented nature of the intervention was becoming clear to everyone. The Japanese would not publicly announce their daily interventions, but the markets began to sense it, and at the end of each month the Japanese would report on the monthly totals.

By the late summer of 2003, the data began to show that the Japanese economy was finally turning the corner. Though it was too early to be sure about the recovery in Japan, it seemed to me that the Japanese could soon begin to exit from their unusual exchange rate policy of massive intervention, and they could call it a success.

Many international policy discussions about exchange rates occur bilaterally, but multilateral discussions are needed too. The International Monetary Fund used to be a forum to discuss and comment on exchange rates policies, but that role seemed to atrophy with the end of Bretton Woods in the early 1970s. The G7 picked up much of the multilateral action on exchange rates and became a natural forum for the United States to discuss exchange rate policy with other countries. Issuing communiqués about the exchange rate remains an important task of the G7 but the formation of the Euro created the need for another grouping to discuss exchange rate issues. For certain issues the G7 was too large, and three of the countries (Germany, France, and Italy) now had the same currency. After discussing the issue with the Europeans and the Japanese, I decided that a “G3” group representing the three major currencies—the dollar, the euro, and the yen—made the most sense. Caio Koch-Weser, the chair of the Economic and Finance Committee which represents the Euro Group, Zembei Mizoguchi of Japan, and I then worked to establish such a regular consultation process.

On September 12, 2003, I received word that the Japanese would ease up on the intervention, and they did begin to reduce their interventions. For a whole week starting on September 12, they did nothing even though the dollar dropped below 116. In fact, it fell rather sharply from 117.4 on September 12 to 114.0 on September 19. It was a sudden movement that surprised the markets and gave us all pause. Exiting from this heavy intervention strategy might be more difficult than we anticipated. The turbulence continued for a few more days and on September 20, at the time of the G7 meeting in Dubai, the dollar also depreciated sharply following release of the G7 statement on the currencies. (After talking to Dino Kos in New York I suggested to John Snow that he give the strong dollar line in his post-meeting press conference and he did, which was enough to offset the dollar’s weakness.)

During the fall and winter evidence of a sustainable recovery in Japan mounted, and I thought that the sooner the recovery became clear, the sooner Japan could exit from its intervention. On December 5, 2003, I gave a speech in New York asserting that Japan was on the road to recovery. It was still a little risky to declare victory that early, but fortunately I was right and the economy had indeed turned the corner. Michael Phillips of the *Wall Street Journal* wrote a piece entitled *U.S. Sees Reason to be Optimistic on Japan Growth* on the morning of my talk saying: "The Bush Administration believes the Japanese economy may finally have turned the corner after more than a decade of little or no growth. In a speech to be delivered today, the Treasury Department's top international official, John Taylor, will credit the Koizumi government's market changes and the Bank of Japan's accommodating monetary policy for giving impetus to the country's laggard economy…The upbeat comments from the undersecretary of the Treasury for international affairs represent a sharp shift in Washington's long pessimistic view of Japan's fortunes."

For the next few months we continued to work with the Japanese on an exit strategy. By early February 2004, the Japanese decided to complete the exit. They had decided to end the massive intervention and they outlined their exit strategy. They would intervene even more heavily in the next month and then stop.

On March 2, Alan Greenspan spoke in New York, explaining how the overall intervention strategy had worked, but that it was now time to stop. As usual he used the somewhat obscure language of a central banker, but the message was clear: "…partially unsterilized intervention is perceived as a means of expanding the monetary base of Japan, a basic element of monetary policy. In time, however, as the present deflationary situation abates, the monetary consequences of continued intervention could become problematic. The current performance of the Japanese economy suggests that we are getting closer to the point where continued intervention at the present scale will no longer meet the monetary policy needs of Japan."

Friday March 5, 2004, marked the start of what I would later call the real end of the intervention. At 8:30 that morning, Washington time, the U.S. Labor Department released their monthly employment report. Employment for the month of February was up by only 21,000 jobs, much less than we or the market had anticipated. News like this would normally have a negative impact on the dollar because weaker jobs data would lower the chances of an interest rate increase by the Fed, thereby making the dollar slightly less attractive to investors seeking higher interest rates. But the dollar did not weaken and on March 5 the Japanese had purchased $11.2 billion dollars that day which made the dollar appreciate rather than depreciate as one would expect. This was not simply smoothing the market. The United States argued that the exit period had gone on long enough.

The Japanese did soon stop intervening, after another week of heavy dollar purchases, but nothing that equaled March 5. The last purchase of dollars occurred on March 16 when the Japanese bought "only" $615 million. On the 17th my Blackberry reported no intervention, and again on the 18th. There was no intervention for the rest of March and the rest of the 2004, and all the way through 2005. Eventually I stopped checking my Blackberry for reports of Japanese intervention. The yen did not strengthen much after the intervention ended March 5. Everyone recognized that the Japanese recovery was solid and that the lost decade was a thing of the past.

CHART 1. Relationship between the exchange rate and periods of strong and weak growth in Japan.

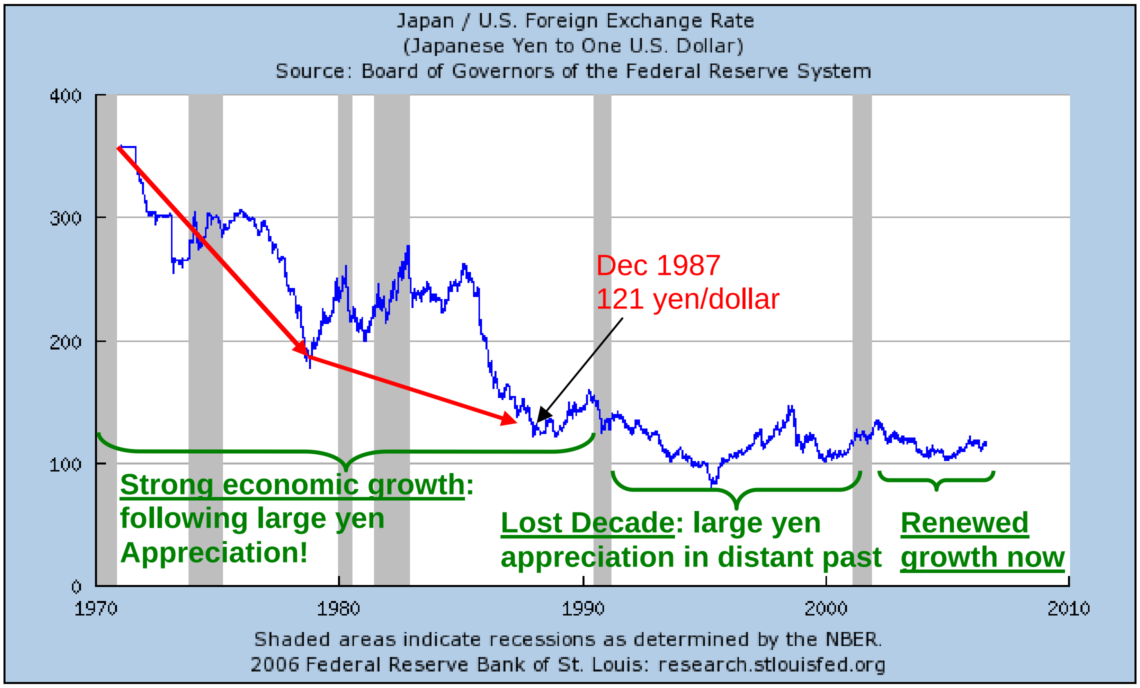

CHART 2. This chart illustrates the re-entry from the zero interest rate policy and is taken from John B. Taylor (2001), "Low Inflation, Deflation, and Policies for Future Price Stability," *Monetary and Economic Studies*, Bank of Japan, February 2001.

Figure 12 After Zero Interest Rate Policy: A Full Specification