

## **How to Create a Recovery through ‘Quantitative Monetary Easing’ We must increase total purchasing power Even economic growth of 4% is possible**

By Richard A. Werner, J[ardine] Fleming [Securities (Asia) Ltd.]

### **Summary**

- (1) The necessary condition for an economic recovery is the new creation of purchasing power. Non-performing loans form an obstacle to the banks’ ability to create this purchasing power, and this is the root cause of the recession.
- (2) At the present time the central bank alone is able to increase purchasing power. It is necessary that it engages in open market purchases of assets and active foreign exchange intervention without sterilisation operations.
- (3) The present recession provides a new opportunity for the speedy development of structural reforms, implementation of which should enable Japan’s long-term growth rate to rise to 4%.

The present recession is Japan’s longest and most severe since the 1930’s, and overall Japan has taken numerous measures to deal with what is widely considered to be very complicated problems. Nevertheless, the root cause of these problems is really very simple. In a word, the problem is “money”: The amount of purchasing power exerted in the economy is not growing fast enough.

The current recession has been caused by the abrupt cessation, indeed acute collapse, of this process of creating purchasing power. And so it is necessary for the authorities to increase the purchasing power exerted in the economy, which in turn would be the key to weaken the yen.

In order to explain the mechanism of achieving an economic recovery, it is necessary to consider the system that creates purchasing power in an economy. Generally, the role of the central bank comes to mind first. But the fact is, the Bank of Japan, Japan’s central bank, furnishes at best a mere 5% of purchasing power, whereas more than 90% comes from the private sector: it is created by commercial banks.

When the private sector commercial banks engage in extending credit to the economy, this is equivalent to ‘printing new paper money’: Increased bank lending injects new, additional purchasing power into the economy, which stimulates demand and produces economic growth. This increased purchasing power is used for an economic transaction, and then returns to the banks in the form of a deposit. This mechanism is called ‘credit creation’, and through this means purchasing power is expanded in an economy.

Things began to go wrong with this process of steady creation of new purchasing power from 1982 onwards. Since that time, private banks have engaged in fierce competition for market share, in order to preserve their ranking in the pecking order of banks. They began to sell too much of their product, which is the supply of credit, and at fire-sale prices. This resulted in an increase of the broad money supply. The funds that were created by banks extending credit with land as collateral were channelled into real estate or stocks. What has since become clear is that the prices of the assets used as collateral were pushed up by bank credit creation, which injected new purchasing power into asset markets, raising asset prices further. The quantity of bank credit creation seemed to grow virtually without limit.

In this way, credit creation vastly exceeded the amount necessary for the “real” economy. According to mainstream economic theory, in this case there should be inflation. However, in actual fact, although money creation continued to outstrip nominal GDP growth, inflation remained low. This has been a major puzzle for economists who have been building their work on the assumption that monetary growth increases proportionally to nominal GDP growth – as shown in Fisher’s or the so-called ‘quantity equation’, whereby the quantity of money  $M$  times its velocity of circulation is equal to nominal GDP.

Richard A. Werner (1995), Keiki kaifuku, ryōteki kinyū kanwa kara, (How to Create a Recovery through ‘Quantitative Monetary Easing’), *The Nihon Keizai Shinbun (Nikkei)*, ‘Keizai Kyōshitsu’ (‘Economics Classroom’), 2 September 1995 (morning edition), p. 26; English translation by T. John Cooke (November 2011)

The solution to this puzzle is simple: It is also possible that money (the total amount of purchasing power) may be channelled towards financial transactions for lengthy time periods. In that case nominal GDP is not directly affected.

Based on this realisation, the author has proposed a division of monetary flows into two distinct streams: the use of money for transactions that are part of the real economy (real circulation credit) and the circulation of money used for financial transactions (financial circulation credit). The excess credit generated in the 1980s by bank lending for real estate transactions constitutes financial circulation of money, and this pushed up asset prices, of both land and stocks. This is why it did not result in inflation in the real economy, as commonly measured by consumer prices.

The accompanying diagram illustrates the author’s calculation of the growth of the effective quantity of purchasing power, as measured by the so-called ‘private liquidity index’. As can be seen from the diagram, in this period where private liquidity has increased much faster than nominal GDP growth, asset prices rose dramatically, while the consumer price index has remained remarkably stable at a low level.

Although the monetary authorities began in 1990 to take measures to restrain credit creation, in order to put a halt to the “asset bubble”, their actions produced a larger than generally predicted negative effect on the overall economy. The necessary condition for the excessive borrowing of the 1980s to persist was that asset price rises would continue and keep producing capital gains. However, as soon as liquidity creation fell, asset prices had to decline, wiping out numerous investors. Many businesses failed, and most of the borrowing that was not based on the real economy inevitably had to turn into non-performing loans in the 1990s (the shaded area in the diagram).

Since 1991 some 60,000 companies have gone bankrupt, to the tune of 32 billion yen. The banks have been landed with bad debts that I estimate at about 20% of annual GDP.

The bad debts are not only a major burden for the banks, but they have been damaging the entire economy. This is because in these circumstances banks have become much more risk-averse, and thus have raised the standards that loan applicants must meet in order to obtain a loan. As a result, small and medium-sized enterprises have no longer been receiving sufficient funding from banks – the main source of their external funding.

However, since SMEs account for more than half of economic activity and some two-thirds of bank lending, new purchasing power was not created, and so the overall real economy could not grow. As a matter of fact, throughout 1994, almost no credit creation was visible in Japan; instead, we saw ‘credit destruction’, which prevented an economic recovery.

In fact, a downward spiral in economic conditions has begun, whereby the supply of credit from banks has stagnated, which has cooled off domestic demand, which in turn has meant that companies have been forced to reduce their sales prices and in line with this, reduce their costs. Corporate restructuring has worsened the labour market situation and produced deflation. These effects combined to further depress consumer expenditure, further increasing the value of the yen, aggravating the downward spiral and resulting in more deflation.

It would take a very long time for the private sector on its own to escape from this downward deflationary spiral, and therefore government intervention is indispensable. But whether the policies adopted by the government are beneficial or not depends on whether they increase the purchasing power in the entire economy. This most crucial point must be made clear, otherwise **government policies aimed at boosting the economy will not prove helpful, and Keynesian fiscal policies will achieve nothing.**

Pure fiscal policy withdraws money from the private sector, as it is funded either through bond issuance or via increased taxes. Pure fiscal policy does not increase overall purchasing power, but merely transfers existing purchasing power from one part of the economy to another. This is the reason why the large fiscal stimulation packages over the past two years have failed to stimulate the economy significantly. For the same reason, the BoJ’s policies, which have focused on interest rates, have not produced sufficient results.

Richard A. Werner (1995), Keiki kaifuku, ryōteki kinyū kanwa kara, (How to Create a Recovery through ‘Quantitative Monetary Easing’), *The Nihon Keizai Shinbun (Nikkei)*, ‘Keizai Kyōshitsu’ (‘Economics Classroom’), 2 September 1995 (morning edition), p. 26; English translation by T. John Cooke (November 2011)

Due to deflation, real interest rates will rise. Simply reducing nominal interest rates will be ineffective. **Even serial reductions in the official discount rate will not be able to stimulate the economy.**

In such a situation the single most vital policy is for the government to act and focus on increasing total purchasing power in the economy. Put simply, the central bank can print money and purchase assets in the markets from participants beyond the banking system. It can intervene in the foreign exchange markets, without sterilising the monetary expansion. In these ways the central bank can inject new purchasing power in the economy. If this were done, then the overall amount of purchasing power in the economy would increase and commercial transactions throughout business would be revived. If such policies were taken, within 6 months we could see a marked improvement in business conditions.

One can point to many historical examples, where, just like now, in a period of credit destruction, central banks have ‘printed money’ and stimulated the economy. These include Japan and Germany in the 1930s, and again more recently, when in 1990 the Federal Reserve adopted a similar policy.

Although one can often hear the argument that Japan’s economic recovery will inevitably have to be slow and fragile, this is not in fact correct. If one increased the total amount of purchasing power effective in the whole economy, then nominal growth would rise.

The present recession has provided the opportunity for Japan to implement a major reform of the inefficient parts of its economic structure. Those factories which produce low value-added products have been relocated overseas, corporate restructuring has advanced significantly, and competition has been increased due to more imports of finished goods and deregulation.

By enacting such changes Japan’s economic system is in the process of changing from a growth orientation centring on exports and industry, to a more balanced economic structure that is more reliant on domestic demand and on service industries which have a higher added value. Consumer oriented industries are basically high value added industries, so that a consumer oriented economic system is able to further raise growth prospects. Consequently, if the BoJ changed tack and earnestly pursued policies to stimulate the economy, the likelihood is high that Japan will be able to return to the path of a non-inflationary potential growth rate of 4%.

The BoJ’s past tight monetary policies have become the target of criticism, but it can also be said that its policies have started a historic structural transformation. At this stage, where Japan’s structural reform has reached a cross-roads, it is precisely by now changing to a policy focused on **quantitative easing** that the Bank of Japan can redeem its prior tight monetary policy stance.

[Ends]