

President's Message



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William Poole

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Lessons from Japan

Now that Japan's economy finally seems to have turned the corner, we can sit back, exhale and consider what we might learn from its slow-motion meltdown over the past 13 years.

Why should we study Japan's troubles? The size of its economy is second or third (different measures yield different rankings) only to ours, and we've often traveled the same paths.

The worst effect of Japan's meltdown was asset-price deflation, with equity prices declining sharply in early 1990 and land prices beginning their long decline in 1991. Deflation in the price of goods started in 1995. Although consumer prices reversed course for a while, they declined in each of the past four years. The falling prices deterred spending by consumers and businesses; they were reluctant to buy because they figured prices would continue to go lower and lower.

Many armchair economists feared that the U.S. economy would follow the same scenario. But deflation didn't visit our shores. Still, our economy had been flat for most of the past three years, only recently picking up steam.

If we never want to go through what Japan has experienced, the first principle we have to accept is that deflation is difficult to forecast. No one in Japan saw it coming, nor did economists elsewhere—even Fed economists.

Second, when deflation hits, easing of monetary policy often isn't enough. The trick is to stop deflation before it gets started by lowering interest rates aggressively and quickly to get people buying again. The Japanese thought they were easing monetary policy in the early 1990s, but they didn't go far enough fast enough—the same sort of hesitation that worsened our own Great Depression. Although interest rates were coming down in Japan, the central bank there was actually holding them up relative to the level required to maintain the economy's stock of liquidity.

Third, Japan showed us that a central bank has more than one tool to work with. Many thought Japan had run out of firepower when it took that one tool—short-term interest rates—down to zero and the economy still didn't respond. But finally, the Bank of Japan implemented a monetary policy focused on quantitative easing.

That policy forced liquidity into the economy, and now economic activity is finally starting to recover.

Japan's problems are deeper than just monetary policy. Problems continue in the banking system, and numerous structural rigidities beset the economy. In contrast, our banks are strong (healthy capital ratios and record profits this year), and flexibility is a key feature of our economy. For example, we have workers willing to move across the country to get a job. Japan doesn't. We're quick to react to changes, in general. They're slow and methodical.

For these and other reasons, what happened in Japan isn't likely to happen here. But we should never say never, especially in view of Japan's being our role model—everybody's role model—as recently as the 1980s.