Why is Monetary Policy Underrated?

TOKYO – Last month – just a few days before the European Central Bank announced its intention to initiate quantitative easing (QE) – I attended a seminar in Geneva with international journalists, policymakers, and investors. The discussions there, much like those in Japan before Prime Minister Shinzo Abe launched his groundbreaking economic-reform strategy in 2012, reflected an inadequate understanding of unconventional monetary policy’s transformative potential.

Indeed, at the seminar, European economists and journalists – especially the Germans, and even some of the Britons in the room – adopted a dismissive tone. “Monetary policy’s power is limited, particularly when the interest rate is so low,” some said. “We cannot count on accommodative monetary policy to spur a portfolio reshuffling,” others added.

These statements were all too familiar – and somewhat surprising, given the progress that Japan’s ongoing QE-based strategy has enabled the country to make. Clearly, many in Europe lack an understanding of the history and significance of so-called “Abenomics”; but such an understanding should inform their monetary-policy debates.

In 2001, the Bank of Japan (BOJ) was struggling to find ways to help the economy escape recession. Having already reduced the target short-term interest rate to very close to zero,
it turned to open market operations – specifically, purchasing long-term government bonds and increasing bank reserves held at the BOJ – in order to increase the money supply and reduce long-term interest rates.

But the BOJ’s attempt at QE proved to be too little too late, and no recovery materialized. Ben Bernanke, then the chairman of Princeton University’s economics department, took note of this failing, declaring that the BOJ should pursue a more aggressive monetary policy.

When the US investment bank Lehman Brothers collapsed in 2008, triggering a global financial crisis, Bernanke – who had since become US Federal Reserve Chair – took his own advice, instituting a bold QE program to revive the United States’ moribund economy. The United Kingdom, too, pursued robust QE – and, like the US, it is now experiencing relatively strong economic growth (which is why the British participants in Geneva should have known better).

Japan, by contrast, hesitated to expand its money supply substantially, leaving the yen’s exchange rate against the US dollar to appreciate to 76 (from less than 100 before the Lehman crisis), and causing GDP growth to decline further. In 2009, Japan’s economy was performing at 8% below potential, even though its financial system was sound. In short, the Japanese economy suffered far more than the US and UK economies, which were directly affected by the Lehman shock.

A small group of economists, including me, recognized this discrepancy, and argued strenuously that monetary easing was critical to fight deflation and extreme currency appreciation. But our arguments were consistently dismissed. Sound familiar?

Abe changed everything. With monetary policy as the basis of his political agenda, he became Prime Minister (for the second time) in December 2012.

Soon after, QE was off and running. Almost immediately, the yen depreciated, exports increased, and the stock market soared. After nearly two decades of recession, the Japanese economy was growing again – and it had Abenomics to thank for it.

Of course, everything did not go entirely smoothly; a 3% consumption-tax hike, which had been put in place by the previous government, interrupted Japan’s progress. And Japan still has a long way to go to achieve robust long-term economic growth, with the next phase of Abenomics – supply-side reforms – requiring the government to overcome resistance from bureaucrats and special interests.
Nonetheless, QE’s effectiveness was clear – so clear, in fact, that last October the BOJ announced an additional round of it. Judging by the overwhelming victory of Abe’s Liberal Democratic Party in a snap general election two months later, Japanese voters are satisfied with this approach.

Now it is Europe’s turn to benefit from the power of monetary policy. But, for the ECB’s plan to work, its QE must be robust – and that will require broad support. After all, eurozone monetary policy is the product of joint decision-making within the ECB governing council, where Germany’s influence is strong.

Given QE’s success in the US, the UK, and Japan, attracting such support should, one might assume, be relatively easy. Yet my experience in Geneva was not an isolated incident; many policymakers remain convinced that monetary policy is not all that powerful. At last year’s World Knowledge Forum, several leading central bankers – including former BOJ Governor Masaaki Shirakawa, former ECB President Jean-Claude Trichet, and former Bank of Korea Governor Kim Choong-soo – also dismissed the potential of unconventional monetary policy.

The belief that monetary policy does not matter is not just “the most dangerous idea in Federal Reserve economic history,” as the economists Christina and David Romer have noted; it is exceedingly hazardous to any economy. Europe faces enough serious risks already; it should not needlessly add to them.


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