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The Role of Preconceived Ideas in Macroeconomic Policy: Japan's Experiences in the Two Deflationary Periods

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Koichi Hamada and Asahi Noguchi

Abstract

This paper examines the role of misleading economic ideas that most likely promoted the economic disasters of the two deflationary periods in Japanese economic history. Misleading ideas deepened the depression during the interwar years, and erroneous thinking prolonged the stagnation of the Japanese economy since the 1990s. While the current framework of political economy is based on the self-interests of political agents as well as of voters, we highlight the role of ideas in policy making, in particular, in the field of macro-economy where the incidence of a particular policy is not clear to the public. Using two significant examples, this paper illustrates the role of *preconceived ideas*, in contrast to economic interests, that dominantly influenced economic policy making.

Keywords: Preconceived ideas, perception on economic mechanism, vested interests, great depression, deflation in contemporary Japan

JEL Codes: B2, F4, N2

I. Introduction

This paper examines the role of misleading economic ideas that catalyzed the economic disasters of the two deflationary periods in Japanese economic history. Most likely, erroneous thinking deepened the depression during the interwar years and misleading economic understanding prolonged the stagnation of the Japanese economy since the 1990s. The influence of economics on political science in recent years has generated the following paradigm: all agents are motivated by self-interests, notably economic interests, and the force of conflicting interests interjected through political parties is usually more essential than the technical interventions of bureaucrats.[1] While we do not basically refute the current framework of the political economy based on the self-interests of political agents as well as of voters, we, at the same time, highlight the role of ideas in policy making, in particular, in the field of macro-economy where the incidence of a particular policy is rarely clear to the public. In this paper, we present two significant examples in which erroneous thinking rather than conflicts of interest apparently misled the policy decision-making in Japan's macroeconomic history. Thus we seek to reexamine the role of preconceived perceptions in contrast to economic interests and factors as influencing policy making.

This paper is motivated by a prolonged recession in Japan that endured since the 1990s and was aggravated under continuing deflation during the past several years. The principle of economics tells us that deflation, the decline in the general price level, is a monetary phenomenon. The statement is obvious from the simple fact that the general price level is a reciprocal of the price of money measured in terms of bundles of goods. One of the basic triggers for chronic deflation combined with recession since the 1990s was the too abrupt, miscalculated monetary contraction aimed to halt the asset price boom, or bubble, in the late 1980s. As economists in the Federal Reserve Board (FED), Ahearne et. al., (2002) admit, the Bank of Japan (BOJ) had good reasons for making excuses for the error because the situation was almost unprecedented in the postwar world economy. Thus, in order to cope with the problem, the first resort was to utilize monetary policy, and, as it happened, if conventional monetary policy did not show positive results immediately, new instruments of monetary policy needed to be examined and tested.[2].

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[1] Gary Becker (1983) and George Stigler (1971), among the influential authors on this subject, emphasized the framework that politicians and bureaucrats are also optimizing their objectives in the political markets. Ramseyer and Rosenbluth (1993) apply this view to Japan's political economy and claim, contrary to the conventional view of stressing the role of bureaucrats, that politicians, principals, are more influential than their agents.

[2] Needless to say, we never discount the merits of microeconomic structural reforms including

To our surprise, many policymakers, journalists, policy-oriented economists (*ekonomisuto* in Japanese) and even academic economists in Japan argued that deflation is a microeconomic structural problem. There were many credos: "Deflation is not a monetary problem," "Deflation should be remedied not by monetary policy but by government expenditure policy," "Deflation originated from technological innovations and from inexpensive imports is a blessing." Some of them even further claim: "Deflation should not be halted by monetary policy or exchange-rate policy, because deflation helps the rationalization, that is, the Schumpeterian creative destruction."[3]

In microeconomic matters, most policies have well-understandable impact on the constituency. It is usually in macroeconomic issues, on the other hand, that the incidence of economic policy is much less clear. Hardly anybody would doubt that the reduction of high tariff rates hurts the interest of rice farmers at least in the short run. In cases of inter-industry conflicts or conflicts between factor owners that are associated with microeconomic policies, the public has little difficulty in understanding who gains or who loses from a certain proposed economic policy. In such cases, group-oriented and sectarian interests can be represented by various groups and agents in a country. On the other hand, many people in Japan were persuaded by a contention that deflation would be beneficial to the economy as a whole, although it is actually the view that contradicts the standard understanding in economics.

Japan had a grave experience of economic policy failure in history that caused serious consequences in the lives of the Japanese during the inter-war years of the 1920s to 1930s. Policy makers as well as a majority of economists misunderstood the effects of macroeconomic policy on the restoration of the gold standard at the prewar parity. Many of them, with the notable exception of Tanzan Ishibashi, Kamekichi Takahashi and a few others at the *Toyo Keizai Shinpo* (the *Oriental Economist*), erroneously believed that deflation, triggered by the return to the gold standard, would cure structural problems that seemed to plague the Japanese economy

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deregulation and the clearing of the outstanding, enormous, nonperforming debt for correcting the situation. The delinquent debt problem came, of course, partly from real decline in productivity in the Japanese economy, but also from the monetary policy shocks and resulting asset market crashes (see Sheard, 2001, and Hamada, 2003).

[3] One of the authors of this paper presided over a Cabinet Office in the government for two years from 2001-2003, and observed and partially participated in the process of designing and implementing macroeconomic policy under deflation. The other participated actively in macroeconomic debates in academic and journalistic venues and argued against the doctrines that contradict the basic economic principle in macroeconomics. We developed our concern about the serious consequences of economic illiteracy and are now convinced of the need to highlight the importance of proper understanding of economics in determining macroeconomic policy.

after World War I. The government took a reckless step toward returning to the gold standard with the old parity that had prevailed before World War I. The results were serious depression, deflation, and massive unemployment during those periods -- a situation that might have ultimately driven Japan into World War II.

Three quarters of a century later, that is, during the last ten years, the Japanese economy regrettably made almost exactly the same kinds of mistakes after the same kinds of debates. A nation suffers from deflation apparently not because of the conflict of social interests but because of ignorance or misguided thinking concerning economic logic. It is not necessarily the restraint from conflicting interests but the misperception on the parts of economic actors, policy makers and economists that exacerbated the deflation and recession since the 1990s. This paper aims to explore the consequences of mistaken but firmly held ideas about economic mechanisms, during Japan's interwar period between WWI and WWII, and during the post 1990s recession.

In Section II, as a positive theory of political economy, we contrast the two views concerning what motivate economic policy. One view emphasizes the interests of sectors, groups, politicians and government officials. The other view emphasizes the preconceptions, ideas and epistemological culture (Haas, 1992; Blyth, 2002). While we do not deny the significance of group interests and accompanying incentive mechanisms in Japan's political scene, we focus rather the importance of conceptual or epistemological aspects of policy formation processes. The role of ideas and mistaken ideas, which are relatively neglected in recent literature, should be taken more into account particularly in a field where the incidence of policy actions is far from obvious and, therefore professional knowledge needs to be seriously considered.

In Section III, we briefly review the literature that contrasts the power of vested interests with the power of ideas in policy making. We explore the possibility of how the role of perception can be explicitly introduced into decision theoretic models.

Then, in the subsequent two sections, we present two examples that illustrate how erroneous thinking misled the Japanese economy. The first example in Section IV was the erroneous notion, popular during the interwar years, that the return to the gold standard with the pre-World War I old parity would restore strength to the economy. We analyze the opinions in newspapers to find how prevalent this notion was. In Section V, we present the second example, that is, the erroneous perception about deflation in deflationary Japan after 2000. For this period, there is a database from which we can systematically extract relevant editorial opinions from the newspapers that would illustrate how they were arguing wrongly about deflation as well as the policy in place during that circumstance.

In the concluding section, we offer two questions for further research. One question is: Given that some ideas were in error and misleading for macroeconomic policy, were these ideas generated independently, or as a result of manipulation by pressure groups? The second question is: How, if at all, can our approach that emphasizes the role of mistaken ideas be embedded into the science of policy advising? (See Frankel 2003)

II. Erroneous Ideas vs. Vested Interests

Since economic policy affects the interests of many groups in a nation, economic policy making in the real world cannot be solely guided by the logic of economics. A specific economic policy has a different impact on different groups in a society. Pursuit of economic logic in the process of economic policy making is undone by the consideration of specific interests. Even if a policy is considered to be beneficial to a nation, the interest of a particular group may be unfavorably affected so that the group will block the implementation of such a policy. For example, free trade is considered to be beneficial for a nation as a whole, but some interest groups may strongly oppose it.

The importance of interest groups is emphasized by many authors in the field of political science. The so-called "liberal international political economy" (see Putnam, 1988; Moravcsik, 1993, for example) is a systematic pursuit along this line in international relations. Admitting the importance of the role of interests, we emphasize another aspect of economic policy making, that is, the role of ideas. Economists trained in sound economic tradition agree that deflation as well as inflation is a monetary phenomenon and monetary policy is the most effective policy assignment. Often, those basic principles are not necessarily understood by the general public. Those principles are ignored by politicians, mass media, and policy makers. In such circumstances, the proper economic policy will rarely be chosen no matter how effective the monetary policy would be in order to cure deflation or inflation.

One uses the phrase "vested interest" when one possesses an absolute or "completed" control of one's interest. We could probably use the word "vested idea" because one finds it difficult to abandon a particular idea if that idea is fixed or "completed" in one's mind. Since erroneous thinking, however, does not necessarily share the sense of exclusivity --rather purveyors of the ideas welcome their dissemination--, in this paper we will call the phenomenon "misguided" or "preconceived" ideas when its logic is erroneous.

We do not deny that group interests in policy making are important, particularly in areas like trade policy or deregulation, where the consequences of particular policies for group interests are more or less obvious. What we contend is that in an area like macroeconomic policy where the consequences of policies are either uncertain or unclear to the public, the role of misguided ideas can be substantial, and the consequences of policies based on mistaken ideas can be rather serious.

Let us compare the roles of vested interests and preconceived ideas. If vested interests obstruct the formation of sound economic policy, then the remedy is to reconcile the conflicts of interests among groups. As Nicholas Kaldor argued (Kaldor, 1939), when there is a gain in the total national economy, say through free trade, there will be a proper means of transfers from those who gain to those who lose. Consequently, the wellbeing of all the groups will be improved. On the other hand, if the formation of a sound policy is obstructed by ignorance or misunderstanding, the remedy is to persuade and enlighten the public with the correct economic logic.

Our working hypotheses are that economic policy making is affected not only by group interests but also by preconceived, mistaken ideas, and that the consequence of translating these ideas into policy is serious where the benefit and cost consequences are seen as ambiguous by the public. In the choice of exchange rate regimes, and in the choice of monetary rules, for example, people often have mistaken ideas about the benefit and cost of policy decisions for a certain group. This mistaken notion can also extend to the benefit and cost of policy decisions for the economy as a whole. It becomes crucially important to correct the mistaken ideas about the economic mechanism.

III. The Role of Perception and Ideology in Policy Formation

As is well known, the two polar views are expressed by Keynes and by Stigler. Keynes' statement in the last chapter in Keynes' The General Theory of Employment, Interest and Money (1936) highlights the power of ideas in spite of short-term or medium term interests. It is so famous that we even hesitate to reprint here.[4] Stigler (1971), on the other hand, stresses the

[4] "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are

effectiveness of incentives and individual interests in the political market. Ideas and perceptions would be reduced ultimately to the interplay of interests since the pursuit of interests is the driving force in political as well as economic markets.

We would like to clarify some of the related context. Years ago, Karl Marx defined "ideology" as a collection of ideas that are structured in such a way so as to enable the group holding power to have maximum control with minimum conflict. According to John Lye (Lye, 1997), ideology can be imposed on others by deliberate persuasion or coercion to alter people's consciousness, but ideology can exist without any deliberate attempt to pressure acceptance. Ideas are made convincing by making them appear natural or "legitimate," or by derivation from historical tradition or intrinsic logic, or externalized as the common knowledge people are supposed to follow.[5]

The prevailing international relation theory, rational choice theory, is considered the appropriate approach to emphasize the role of conflicting interests. As for domestic economy, political scientists, sociologists, and economists have been influenced by this formulation. In addition, the modern treatment of principal-agent relationships enriches the framework.

Ramseyer and Rosenbluth (1993) successfully applied this approach to the political economic process in Japan. They examined the relationship between principals, typically voters and legislators, and agents, typically bureaucrats, as critical to understanding Japan's political economy. They noticed that the "agency slack" in this relationship determined the ease or difficulty in channeling political wills to actual policy making. This view is even more convincing when they consider the observation that the autonomy of even the allegedly most powerful Ministry of Finance, has come under substantial political control.

If we consider these models carefully, we seldom find the emphasis on ideas (an important exception is Blyth, 2002). The emphasis of ideas is, however, not inconsistent with the rational choice theory. Rational choice is conducted for optimizing or satisfying (a la Herbert Simon) behavior under constraints that include what he believes to be the mechanism of the world.

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usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas." (Keynes, 1978, p.383)

[5]By the way, Karl Mannheim contrasted "ideology" as the ideas to keep the *status quo* and "utopia" as the idea to provoke changes (Mannheim, 1936). This distinction will not be developed in this paper.

Perception is a crucial precondition for rational choice. Decision units are behaving under a system of the world view with regard to how their decisions will affect the outcome. The view of the economic universe may be common knowledge to all, but most likely they are different from agent to agent depending on the group classification and the idiosyncratic nature of an agent. Though each rational agent may be motivated by her or his economic motive given the perception of the world, an agent's decision can differ depending upon what kind of view she or he has concerning the mechanism of the economic universe.[6]

Mark Blyth systematically emphasizes the role of ideas. He proposes five hypotheses: (1) in crisis, ideas reduce uncertainty; (2) by reducing uncertainty, ideas make collective action and coalition building possible; (3) in the struggle over existing institutions, ideas are weapons, (4) after the illegitimization of existing institutions, ideas act as institutional blueprints; and (5) after institutional construction, ideas make stability possible. Most of these are reasonable and should be subject to empirical tests. In addition, one should not neglect the existence of ideas that create disorders and even revolutions. His following statement is in any case, highly convincing: "Cognitive mechanisms, *pace* ideas, are important because without having ideas as to how the world is put together, it would be cognitively impossible for agents to act in that world in any meaningful sense, particularly in situations of Knightian uncertainly --. (Blyth, 2002, p.32)"

One may mention slight differences between his and our approaches. First, as the title of his book, Great Transformations, suggests, his work treats many "great' shifts in social policies and institutions. In contrast, we pay attention to rather technocratic policy issues that encounter deflation and depression. Second, economic theory criticized as the "wrong" theory in his book, could at a certain time, become an appropriate theory for recovery of the economy in our context.[7] In spite of these reservations, we find the direction of Blyth's approach to be supportive to our view.

We do not doubt the general applicability of the principal-agent view of the political economy in the large. What we intend is to emphasize the importance of economic perception in order to

[6] Some political scientists who study Japanese society are well aware of the importance of ideas. John Campbell (1992) traces the role of ideas to the endogenous development of economic problems like the government budget and institutions like the social security system in Japan. Curiously, he says, "Policy ideas are like charged particles however, although they can be found in isolation, they tend to attract their opposites. (Campbell, 1992, p.50)"

[7] Some economists who are cited favorably in Blyth (2002) may not agree that deflation is a monetary phenomenon.

understand the success or failure of macroeconomic policies. There are at least three additional grounds to resurrect the role of ideas in the political economy.

First, the degree of "slack" in this principal agent relationship noticed by Ramseyer and Rosenbluth (1993) is crucially affected by the perception and policy knowledge held by both political and bureaucratic actors. As Dixit (1996) demonstrates analytically, the efficiency of the principal agent relationship in the government is affected by the degree of asymmetric information and by the existence of independent objectives that the government as an agent possesses in addition to the objectives assigned by principals. The difference in perception between principals and the agent will make this slack larger.

Second, as Frankel and Rockett (1988) emphasize, it is important for countries to share a common understanding about the macroeconomic mechanism in order to achieve successful international policy coordination. If a government views the world within the monetarist framework, and if another government views the world within the Keynesian framework, then the collaboration would not work. Any policy coordination attempts will encounter difficulties if economic models conceived by nations essentially differ from each other.[8]

Third, in a context of international relations, Haas (1992) juxtaposes the approach that emphasizes ideas, to the rational choice approach. For an international institution or for the international community to work smoothly, the members must share at least a certain degree of common perception. An international community thus functions as the "epistemic" society as defined by Haas.

Of course, an epistemological society, or club, may actually be a hurdle for new comers or an obstacle against introducing new innovations. If the epistemological requirement works as a protocol that suppresses new innovations, it may turn out to be a public strain instead of a public good. For better or worse, an epistemological society may work as the instrument of displaying "soft power" by the incumbent countries. For example, the plan to build an Asian Monetary Fund (AMF) by Japan was rejected, not merely because of the mere difference between the interests possessed by Japan and those possessed by other developed countries, but also because the AMF was suspected to be a potential threat to the epistemological community around the IMF.

[8] This phenomenon is not necessarily unique for international policy coordination. Even within a country, if different agencies perceive different economic models, the same outcome will take place.

We can learn much from cognitive psychology when we study what brings about the change in perceptions. The conventional view in economics is the Bayesian way of treating a change in belief from prior probability to posterior probability after observations. The existence of multiple prior probability distributions gives different implication from what the Bayesian view brings. Moreover, the phenomenon of "cognitive dissonance" (Festinger, 1957; Akerlof and Dickens, 1982) tells a different story from the Bayesian inference. According to the "cognitive dissonance" theory, individuals are reluctant to recognize that which is contradictory to one's belief because they do not like the inner conflict that results between one's belief and new observations.[9] One does not change perception easily if such a change causes discomfort arising from the conflict between one's existing beliefs and new incoming observations. The same kind of resistance to a change in ideas is seen in the process of changing the "paradigm" in an academic community. (Kuhn, 1962)

We attempt to resurrect the role of ideas in a policy choice of an administrator, a political choice of representatives, and an economic choice of a private agent. To repeat, we admit that each policy maker or each politician behaves more or less on his (her) own selfish ground. If perception of the economic universe is different among agents, and often erroneous, however, the aggregate outcome can be distant to the desirable outcome. Our hypothesis is: the contribution of preconceived ideas is serious where the benefit-cost consequences are ambiguous to the public. It is serious where, for example, the benefit-cost structure about the choice of exchange rate regimes or about the choice of monetary rules is not perfectly clear to the public.

If the ideas are important, then it is beneficial for a group of people to change the ideas that another group of people possesses. Ideas work as ideologies in the sense discussed by Marx. The modern world will then become a world of competition for manipulating or framing ideas as well as images. A game-like situation will emerge as to how to imbed the most beneficial ideas within the related parties. The examples below seem to indicate, however, that often ideas themselves work as triggers to economic policy. Indeed, ideas may be manipulated by vested interests. When the matter is highly technical, as in the case of the return to the gold standard or liquidity trap, misleading ideas can function alone as detrimental for successful macroeconomic performance as will be demonstrated below. Moreover, if most of the actors act on inaccurate beliefs and misguided frameworks in viewing the world, then the policy outcome will be different from what is desirable for the ultimate and legitimate principals of the economy, that is,

[9] In the recent election, one might find it unsettled or uncomfortable to watch a particular channel, i.e. the Fox Cable News or CNN depending on one's political propensity.

the individual actors in a nation.[10]

IV. Episode I: Returning to the Gold Standard During the Interwar Years

IV-i. Economic Disasters Resulting from the Obsession with the Gold Standard

The reconstruction of the international gold standard after World War I (WWI) was a clear example in economic history that manifested the danger of adhering to preconceived ideas in policy choices. After WWI, industrialized countries seriously explored ways to rebuild the international gold standard. This issue was the main agenda both for the Brussels Conference in 1920 and the Genoa Conference in 1922. Eventually, most of the countries decided to return to the gold standard at the prewar parities.

At the beginning of the 1920s, discussions of how to restore the international gold standard were still confined to a rather limited circle. The discussions were conducted by two different groups of people; policy experts, politicians, and the public on one hand, and some leading economists on the other. Even at this earliest stage, there was an insurmountable discrepancy between the opinions of the first group and those of the second. Politicians, policy officials, and journalists mostly held the position that the early return to the gold standard at the prewar parity was a prerequisite for remedying confusion from the war and restoring normal economic conditions that prevailed before the war.

On the other hand, some foresighted economists were strongly opposed to this conventional view. The group included John Maynard Keynes, Irving Fisher, and Gustav Cassel, unquestionably the most prominent economists at that time.[11] They thought that the return to the gold standard, if it were done at all, should be carried out at a devalued parity that would reflect the ongoing relative value of the currency to gold. Some of them went so far as to contend that the gold standard system itself should be modified or replaced by a certain more rational currency system. Fisher (1913; 1920) advocated the “compensated dollar” plan that purports to stabilize the dollar price of basket of goods and services, i.e., the general price level, by appropriately changing the dollar price of gold. Keynes in his Tract on Monetary Reform (1923) (Keynes, 1971) argued for the managed currency system without gold, an idea which

[10] Hoover (2003) contrasts three great social philosophers, Keynes, Laski and Hayek, whose thought delineated major intellectual tendencies in the 20th century. The subject of this paper explores less lofty ideals, that is, ideas in terms of technical understanding of economic logic.
[11] Their writings closely associated with the topic are Cassel (1921), Fisher (1922), and Keynes (1977).

would become popular later.

The economic reasoning behind these economists' suggestions was straightforward and could be summarized as follows. During World War I, many countries were forced to suspend the gold conversion of their currencies since they were obliged to spend large amounts of government funds, ultimately financed by central banks. In order to make this possible, most of the countries had to do nothing but abandon the gold conversion of their currencies. That was the primary discipline for conducting monetary policy under the gold standard.[12] In the process of this money financing, the monetary bases of these countries inevitably expanded, and many countries came to suffer from fierce inflation immediately after the war. Generally speaking, moderate monetary tightening by central banks is the most efficient way for suppressing inflation. At the period after WWI, however, when a country aimed to restore the gold conversion of its currency at the parity that had existed before inflation, the country had to contract drastically its monetary base in order to make it sufficient to restore the price level before the beginning of WWI. Deflation and the economic stagnation associated with it would be an inevitable consequence of the required monetary contraction. In the long-run, this process of deflation is a transitional and temporary process of monetary adjustment, and the economic distress would be eventually remedied as the prices continued to be reduced adequately. Nevertheless, the necessity for such a policy of monetary contraction and deflation was extremely dubious. The economists argued, in view of the substantial cost of deflation during the process, that each country should not restore the previous value of its currency, but stabilize the currency around its existing value.

It might be noted that a policy to return to the gold standard at the old parity had legitimate economic justifications of its own. As argued in Bordo and Kydland (1996), the gold standard could be interpreted as a contingent rule that would prevent an undesirable outcome as far as time inconsistency of a government policy. In this context, adhering to a predetermined gold parity is crucial since a violation of it would inevitably lead to a loss of credibility for a commitment to the rule. In fact, Gustav Cassel approved Britain's return to the gold standard at the prewar parity, although he condemned "the idea of a deflation, bringing back the value of that money to its pre-war level, is altogether Utopian," (Cassel, 1921, p.63). It is likely that Cassel thought Britain's gain from retaining the commitment would more than compensate for the loss from deflating the economy in this case. In general cases, however, the economists who

[12] The gold standard system was, above all, a system of rules for the member countries to conduct their monetary policies. For a systematic representation on the "rules of the game on the international gold standard system," see McKinnon (1993).

were opposed to the prewar parity return to the gold standard thought, quite rightly, that the cost of deflation would far exceed the gain from keeping the commitment.

Unfortunately, the views of the above economists, though foresighted, were hardly accepted outside academia. They were considered by the general public to be academic eccentricity, and were never taken seriously by policy makers. This is shown most apparently by the fact that a large majority of the countries returned to the gold standard not at devalued parities but at prewar parities.[13] What occurred to these countries after the restoration was, however, exactly the situation that had been anticipated and forewarned by the economists, that is, severe deflation and stagnation with increasing unemployment.[14]

It is important to notice that the countries making these decisions to return to the gold standard at the prewar parity had usually made it with strong public support. Apparently, there was what we may call a preconceived idea on the part of the public. The idea was contradictory to that of experts, primarily, those outstanding economists. Unfortunately, it was not the economists' thinking but the preconceived, mistaken idea that dominated the actual course of policies during the restoration phase of the international gold standard.

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[13] The general proposals of the Genoa Conference in 1922, to which Keynes made some actual contributions, appropriately affirmed the option of devaluation by a member country. However, Keynes had to make strong accusations to the officials of member countries attending there: "Signor Peano, M. Picard, and M. Theunis, speaking on behalf of Italy, France, and Belgium, announced, each for his own country, that they would have nothing to do with devaluating, and were determined to restore their respective currencies to their pre-war values. Reform is not likely to come by joint, simultaneous action. Experts of Genoa recognized this when they 'ventured to suggest' that 'a considerable service will be rendered by that country which first decides boldly to set the example of securing immediate stability in terms of gold' by devaluation," (Keynes, 1971, p.118n). Cassel, another prominent participant of the Genoa Conference, made a similar suggestion: "it is perhaps not easy for a younger generation to realize how much opposition was raised against the recommendations of the Conference with regard to the choice of new gold parities. Governments and central bank authorities had not yet clearly understood that substantial alterations in the values of the several currencies had taken place. They still entertained the idea that a restoration of pre-War gold parities was possible, and indeed was the only 'honest' solution of the monetary problem," (Cassel, 1936, p.31).

[14] The most typical example was the case of Britain after 1925. Winston Churchill, then the British Chancellor of the Exchequer, realized Britain's return to the gold standard at the prewar parity with overwhelming public support. Immediately after this, Keynes, who had always been at the forefront of the oppositions to the restoration of the gold standard at the prewar parity, published a pamphlet to criticize this policy. This book entitled <u>The Economic Consequences of Mr. Churchill</u> (1925) (Keynes, 1981, 5) accurately predicted economic difficulties that occurred to Britain after that, namely, deflation, unemployment, and social turmoil. This is probably one of the reasons that Keynes compared himself to Cassandra, ignored prophetess in Greek mythology, in his preface of <u>Essays in Persuasion</u> (1931) (Keynes, 1972).

The above mentioned economists at that time had accurately predicted the disastrous outcome that would emerge from the policy of returning to the gold standard at the prewar parity. The significance of this prediction is confirmed by the modern "international view" on the Great Depression, the view developed by Temin (1989), Eichengreen (1992), Bernanke (2000b), and others.[15] The international view verifies that the gold standard rebuilt after the WWI was exactly the prerequisite for the world economic crisis that followed. Under the gold standard system, every country must tighten domestic credit when gold reserves fly out, and monetary tightening by one country would inevitably lead to monetary tightening by another. The same mechanism would be provoked if a country attracting gold from outside tried to prevent its monetary base from expanding by sterilizing the influx of gold. Thus, the international gold standard system has an indigenous tendency for mutual monetary contractions. The worldwide diffusion of depression in the 1930s was nothing but a realization of this systematic monetary tightening process, where negative monetary shocks were transmitted like a chain reaction from one country to another through an outflow of gold that triggered additional monetary tightening. The most apparent evidence for this hypothesis is that no country could escape from being involved in deflation while adhering to the gold standard. As Bernanke (2000b, ch.3) has shown, it was not until a country abandoned the gold standard and ensured a freedom of monetary expansion that the country could find a way to escape from the depression.

These studies suggest that the insight of forward looking economists who opposed the return to the gold standard at the prewar parity turned out to even more prescient than they themselves thought when they presented it. Conversely, the general belief at that time that the gold standard system was an indispensable prerequisite for economic stability was erroneous and more harmful than first thought. It was exactly this misguided idea that paved the way to the world economic crisis that generated one of the unprecedented economic disasters in the 20th century.

IV-ii. The Controversy Around the Restoration of the Gold Standard and Its Consequence

Japan seceded from a feudal state and became a modern national state during the "Meiji Restoration" of 1868. After the Sino-Japanese War (1894-1895), with reparations from China, Japan moved from a gold and silver bimetallic standard to a genuine gold standard in 1897. Thus, Japan became a part of the international gold standard system prevailing in the world at that time. Although Japan was not a major factor in WWI, it followed the other countries by suspending the gold conversion of its national currency in 1917. As soon as the war ended,

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[15] It is Eichengreen and Sachs (1985) that provided a momentum for this research program. Temin (2000) concisely summarized the common understanding of this framework.

therefore, the problem of returning to the gold standard, namely the question of how and when Japan would return to the gold standard, became the policy agenda of national priority. It was not until 1930, however, the year in the midst of the world economic crisis, that Japan undertook the act of a return to the gold standard after a long series of debates.

Similar to other countries contemplating their return to the gold standard in the 1920s, extensive debates, called the "kin kaikin" (repeal of the gold embargo) controversy, emerged in Japan involving both academics and journalism. The repeal of the gold embargo at that time was synonymous with a return to the gold standard. The controversy on the repeal of the gold embargo, one of the most heated controversies throughout the whole Japanese history, was echoing controversies in other countries. On one hand, a small number of economists were strongly opposed to Japan's returning to the gold standard at the prewar parity. On the other hand, the majority of people, both in academics and in journalism, believed in the need to return to the gold standard at the prewar parity.

Probably, a peculiarity in the Japanese case compared with the cases of other countries was that the economists opposing the restoration to the prewar gold parity were not professors in universities but economists in the private sector. The four most conspicuous figures in this camp were Tanzan Ishibashi, Kamekichi Takahashi, Toshie Obama, and Yasuzumi Yamazaki. These people, sometimes called the "gang of four" in favor of the devalued gold parity restoration, were all economists or journalists who wrote articles and editorials for economic magazines and newspapers, and were not academics. Most of the economics professors in universities were supporters of the old gold parity restoration.[16]

Most of the economists for the devalued gold parity restoration were not academic scholars, but their economic knowledge and their capability to understand current levels of economics much surpassed their opponents who were mostly in universities. They were far more familiar with the contents and the context of the debates developed overseas on this subject. Actually, it was from the arguments made by Keynes, Fisher, Cassel, and others that Tanzan Ishibashi and Kamekichi Takahashi obtained a theoretical basis for their opposition to Japan's prewar gold

[16] Their representatives were Kiichi Horie of Keio University who wrote an article, "Let the depression proceed to its utmost end" in 1925, Seibi Hijikata of the Tokyo Imperial University who published a book <u>The repeal of the gold embargo</u> in 1929, Tokuzo Fukuda of the Tokyo Commercial University, one of the most renowned economic scholars at that time, and Hajime Kawakami of the Kyoto Imperial University who was a pioneer of Marxist economics in Japan. Economic scholars for the devalued gold parity restoration such as Senjiro Takagi of Keio University, who had studied economics and obtained a doctorate under the mentoring of Irving Fisher, were quite exceptional.

parity restoration.

Just before the Genoa Conference in 1922, Keynes wrote an article entitled “The Stabilisation of the European Exchanges: A Plan for Genoa,” and presented his own proposal for reforming and reconstructing the international gold standard system that had broken down during WWI. This article was finally published in a series of special supplements of his own, in the Manchester Guardian Commercial. At the Conference, Keynes worked for the Financial Commission with the other experts such as Ralph Hawtrey and Sir Robert Horne, then the British Chancellor of the Exchequer, who drafted the general proposals of the Commission. On this occasion, Keynes also edited twelve volumes of the “Reconstruction in Europe,” supplements in The Manchester Guardian Commercial, a series of newspapers published only from April 1922 to January 1923. This series contained Keynes’ own articles that were to make a core of his Tract on Monetary Reform (1923), as well as the other significant writings of Arthur Pigou, Irving Fisher, Piero Sraffa, and Gustav Cassel. It was not long before the contents of this series reached Japan. The *Toyo Keizai Shinpo* (the *Oriental Economist*), 10 June 1922, published a summary article of Keynes’ “The Stabilisation of the European Exchanges: A Plan for Genoa,” in The Manchester Guardian Commercial, 20 April 1922. It was Kamekichi Takahashi, then an in-house writer of the *Oriental Economist*, who wrote this summary on Keynes’ idea. This brief article by Kamekichi made a memorable first strike for subsequent arguments on the devalued gold parity restoration in Japan.

However, the apparent intellectual superiority of these opponents to the return to the gold standard with the old parity did not translate in the superiority in their practical influence on policies. Above all, the opponents remained in the minority. Among the economic media, the *Oriental Economist*, that was a base camp for Ishibashi and Takahashi, was the only journal that expressed overt support for the devalued gold parity restoration. The other journals and newspapers were virtually dominated and preoccupied by the arguments for the prewar gold parity restoration.

After these heated debates, Japan eventually returned to the gold standard at the prewar parity on 1930. Jun-nosuke Inoue, then the Finance Minister of Osachi Hamaguchi cabinet, initiated this task. Since its start on 1929, the Hamaguchi Cabinet had placed the task of returning to the gold standard as its primary policy objective. In August 1929, the cabinet disseminated large-scale propaganda aimed at obtaining public support for the repeal of the gold embargo and the tight-money policies required, using various means of public communication from radio broadcasting to distributing 13 million sheets of political leaflets. The public welcomed it! The motto "repeal of the gold embargo" became a fashionable. Major newspapers at that time such as the *Osaka Mainichi* and the *Osaka Asahi* also welcomed this policy stance of the Hamaguchi Cabinet, and actively expressed support for the policy plan. These newspapers had already been extensively involved in a voluntary campaign asking to "carry out the repeal of the gold embargo right now."

The thinking of Inoue, who completed the repeal of the gold embargo on his own, can be easily seen in his booklets titled <u>The Restoration of National Economy and the Repeal of Gold Embargo</u> (Inoue, 1929a) and <u>The Repeal of Gold Embargo: An Appeal to all of the Nation</u> (Inoue, 1929b). These books contained many popular rhetorical expressions of the time: "customary falsehood would remain if a temporary relief were made through the devaluation of gold parity," "it would spoil people's spirit to make efforts for the economic recovery, and result in a retreat from the original purpose of the repeal of gold embargo," "we cannot avoid fiscal tightening and liquidation of business at least once in the process," and "the wisest and the surest way is to go straight toward the repeal of the gold embargo at the prewar parity since we cannot avoid some pains and some sacrifices anyway."

Japan undertook the return to the gold standard at the prewar parity with the overwhelming support of the public.[17] The result was a disaster. What happened there was exactly the state of affairs that had been accurately anticipated by foresighted economists, i.e., an unprecedented economic crisis associated with fierce deflation. What ensued is called the *Showa Depression*. This economic crisis eventually led to social turmoil as the population became more and more discontent. In such an atmosphere, the Prime Minister, Osachi Hamaguchi, was shot by a fanatic fascist and seriously injured. The Hamaguchi Cabinet collapsed. Moreover, Britain abandoned the gold standard on September 1931. After that, Japan became a target for selling the yen, which was provoked by the anticipation that Japan would leave the gold standard in the near future. In this circumstance, Japan was eventually forced to leave the gold standard again on December 1931. This decision was made by the Tsuyoshi Inukai Cabinet that had just been established.

Takafusa Nakamura (1967) describes vividly the whole tragic episode that ended with the

[17] A famous anecdote illustrates how the common people at that time were excited by this cold turkey policy espoused by Hamaguchi and Inoue. As preparation for the repeal of the gold embargo, Inoue traveled around the country making speeches persuading the people of the need to endure the pains associated with this policy. At one of these occasions, an old lady, in attendance by chance, was so deeply moved by his speech that she threw a coin toward him. In the Japanese religious tradition, it is not an actual human but a symbol of God or Buddha that is a target for coin offerings.

assassinations of many of major actors, Korekiyo Takahashi, Jun-nosuke Inoue, and Osachi Hamaguchi. Nakamura mentions, it would be fair to point out, that behind the doctrinal difference towards the exchange rate policy existed certain differences in interests. Business leaders from Zaibatsu, represented by Takuma Dan (who was also assassinated) and Seihin Ikeda, might have liked the stability and a low-pressure economy for their material interests. We cannot imagine, however, that the return to gold standard was solely triggered by their business interests.

IV-iii. Discussions in Japanese Newspapers on the Restoration to the Gold Standard

In Japan as well as in the rest of the world, there was a notable difference of opinions concerning the return to the gold standard between the leading economists at that time and others, i.e., politicians, policy officials, journalists, and the general public. The differences of opinion reflected the differences between sound economic reasoning and the ideas preconceived by conventional thought.

What was actually the substance of the preoccupied ideas espoused by conventional thought? We can easily trace the opinions expressed by Keynes, Fisher, Ishibashi, and (Kamekichi and Korekiyo) Takahashi(s) by their writings. Similarly, we can trace the opinions of those, like Jun-nosuke Inoue, who cherished the restoration of the gold standard with the old parity by their addresses and writings as well. However, since the idea largely shared by the general public seemed to have been far more influential with respect to actual policies, the public opinion should be paid more attention. There were no direct sources of public opinion or the preconceived idea possessed by the people. What we can do is to consider newspapers' editorials as a documented proxy of the public opinion.

There are several reasons for assuming that opinions appearing in newspapers should be good reflection of preconceived ideas held by the general public. A majority of readers of the major general newspapers are not socially elite or the *intelligentsia,* but ordinary citizens with average literacy. Therefore, newspapers are intended to play a social role in the communication between actual politics and the general public. Newspapers are always exposing information on policy subjects of national interest to various levels of people. They often express a specific opinion on a particular policy subject, and by so doing they evoke a broader understanding of the subject. In many cases, an opinion expressed in a newspaper is not the one held by an individual writer, but the "house view" that reflects a specific policy stance of the newspaper. This is precisely the case of "editorials" in Japanese newspapers. In many instances, views and opinions expressed in newspaper editorials are thus good representations of public sentiment. Since newspapers are also commercial media, they must represent at least some aspects of the public opinion in order to survive in the market.

There can be various kinds of interactions to editorials and other opinions expressed in the newspapers. Newspapers expose the general opinions or sentiments of the public. On the other hand, newspaper may attempt to change the general opinions of the public. If the latter channel is workable at all, then politicians, administrators, business circles and NGOs will try to influence newspaper opinions. In this study, we emphasize the first channel, but further research is needed on the mutual interdependence and the strategic behavior surrounding the newspapers.

Muneyoshi Nakamura, a historian from Daito Bunka University, made an extensive survey of editorials regarding the return and the repeal of the gold standard in the *Osaka Mainichi* (*Daimai*), one of the representative newspapers at that time, from the year 1927 to 1932 (Iwata, 2003, ch.3; Nakamura 2005). His analysis covers the period when controversy was most heated. During this period, repeal of the gold embargo, suspension of the convertibility of gold, and a drastic change toward an expansionary fiscal as well as monetary policy were all made by Korekiyo Takahasi, then the Finance Minister of the Tsuyoshi Inukai Cabinet. We owe a great debt to Muneyoshi Nakamura for all of the following citations from editorials which we translated into English here.

On June 25, 1928, France returned to the gold standard. The next citation is an editorial that appeared the following day.

> "Editorial: France realized the repeal of the gold embargo: Japan should shame itself," *Daimai*, 6/26/1928.
> Now there remain only a few countries, Spain, Portugal, Greek, Mexico, and Japan, that fail to realize the repeal of gold embargo. Why shouldn't we repent ourselves of being left behind if we think our nation is a civilized and first-rate one? . . . We don't need further arguments anymore. We now have seen good examples.

The most curious thing about this editorial is, in addition to the fact that the tone was very emotional, it completely neglected the fact that France returned to the gold standard at the parity devalued almost a fifth from its prewar parity. This editorial was stirring up the waters of pubic emotion rather than making an observation. Nakamura pointed out that this kind of manipulation of the public was quite common at that time.

Around this period, advocacy for the repeal of the gold embargo by the newspaper became more emotional as is seen from the article below:

> "Editorial: The lessons from the reduction of gold specie," *Daimai*, 9/10/1928.
> It is quite unnatural that Japan's economy continues to suspend gold convertibility. We fear that Japan's economy would gradually decline and eventually collapse. The only way we should take is to restore the gold export. It may be painful for a while, but it is a hopeful pain. Eventually it would restore us the normal and stable economic conditions.

On July 1929, the Osachi Hamaguchi Cabinet began. The cabinet immediately manifested the realization of the repeal of the gold embargo and appealed to the public for the patience to endure tightening policies. The newspapers showed overall endorsement of the policy.

> "Editorial: The public should support rationalization" *Daimai*, 7/16/1929.
> If we enforce these tightening policies and make them work, we must endure the greatest pain for a while. We will encounter many undesirable phenomena such as downturn of business and increase in unemployment. However, they are necessary preconditions for restoring the health of business circles. People must endure a pain of surgical operation in order to cure disease. Shrink first in order to extend!

The phrase "shrink first in order to extend" was rhetoric that Prime Minister Osachi Hamaguchi liked to use in his speeches for the repeal of the gold embargo. Before long, it became a familiar cliché that newspapers loved to use. Under such pressure, on January 11, 1930, Japan succumbed and repealed the gold embargo.

> "Editorial: The day for the repeal of the gold embargo has come. Be prepared for the difficulties before us," *Daimai*, 1/11/1930.
> In order to win the international economic battle, we must reduce our national debt in the fiscal side. In the private side, we must rationalize our industries by reducing costs. . . . We hope to transform this memorable day for rehabilitation into our first day toward the fundamental reform of the public and the private economy.

Contrary to expectations, the situation of Japan's economy deteriorated fast after the repeal of the gold embargo. Faced with this change of circumstances, the tone of arguments in the newspapers gradually lost its previous fervor and became more and more defensive.

> "Editorial: A curse is useless for the recession," *Daimai*, 5/11/1930.
> No one is pleased with recession. Many people suffered so much from the recession that they started considering the repeal of gold embargo as a wrong policy. These people now expect a revival of monetary expansion policy. We urge them to reconsider the things more seriously.

As mentioned before, Japan had suffered from attacks for sales of the yen since Britain abandoned the gold standard. On this occasion, the newspapers argued against speculators, contending that their actions were essentially wrong. Needless to say, these speculative attacks against selling the yen were only the result of the anticipation that Japan would be no longer able to maintain the gold standard.

"Editorial: Maintenance of the gold standard," *Daimai*, 11/3/1931.

> Recent outflows of gold from Japan are not the same as those from Britain and Germany because outflows from Japan do not come from foreign withdrawal of short term capital but from speculations by traders in the exchange market. Now that Britain has been suspending the gold standard and that Japanese capital is frozen there, one should in principle be permitted to send gold to the United States to obtain funds for payment. However, this measure should have a definite limit. . . . It is apparent that some traders are intentionally buying dollar with speculative purposes. Speculation is a conduct intended to make unfair profit by infringing the national interest, since it would increase the nervousness of businesses and eventually lead to the suspension of gold export again.

Speculative attacks against the selling of the yen had made Japan's gold reserve decline towards the point of exhaustion. Consequently, Japan released itself from the gold standard system again on December 1931 under the Tsuyoshi Inukai Cabinet. Soon after that, Korekiyo Takahashi, the Finance Minister of the Tsuyoshi Inukai Cabinet, developed expansionary fiscal and monetary policies that were the boldest in the world at that time.[18] These policies

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[18] Hugh Patrick made a clear estimation of what would occur. "It was inevitable that Japan should go off the gold standard, as it did in December 1931. What followed probably could not have been anticipated: one of the most successful combinations of fiscal, monetary, and foreign exchange rate policies, in an adverse international environment, that the world has ever seen," (Patrick, 1971, p.256)

contributed gradually to the recovery of the Japanese economy, and finally lifted it from the world economic crisis. At the first phase of this period, however, the newspapers were quite skeptical and critical about this recovery policy that depended on such expansionary macroeconomic policies.

> "Editorial: The limit to monetary expansion," *Daimai*, 6/20/1932.
> Recent policy for inflation is intended to lower the value of money and to increase prices of goods by issuing more currency. The recovery obtained by such a policy is not a real recovery that would come from restoration of business activities. . . . Some measures for relief of business might be needed. If it went so far as to step forward an excessive expansion of money, however, this policy would break the foundation of our currency system and ruin all of our businesses. . . . We eagerly hope that the government makes every possible effort to contain the inflation within a certain appropriate limit and to prevent various harms that would be generated by inflation.

At the end of 1932, however, the newspapers came to recognize the rational and the forward-looking merit of Korekiyo Takahashi's policy.

> "Editorial: A reflection on business" *Daimai*, 12/31/1932.
> We can notice that more and more countries in the world have been moving toward a policy of reflation in order to resolve depression since the beginning of this year. Incidentally, our nation is running the forefront of this stream. Although it is quite difficult to predict what this stream will bring about in the end, we have clearly realized that its net benefit in this transitional period seems to be substantial. The problem for the next year is how we can minimize the fiscal, economic, and social costs of the ongoing policies, and pave a road toward a true restoration of the balance in government finance and the growth of the private economy.

IV-iv. Significance of a Cognitive Gap in Policy Making

The lessons from the above survey of the editorials can be summarized as follows: At that time, there were apparently two preconceived ideas or myths concerning the repeal of gold embargo. The first myth was the notion that the legitimacy of a currency could not be guaranteed unless the country is in the gold standard system. Most of the media argued that the currency system without gold convertibility would be an unnatural and abnormal system. They supported the restoration to the gold standard as if it were a return to a natural state. Many discussions precisely reflected this notion, that is, what Eichengreen and Temin (2000) called the "gold standard mentality."

The second, quite conspicuous notion was that a sound economy would be secured only through a painful process of competition and survival, that is, through the risks of bankruptcies in the market. This sort of thought may be properly called the "liquidationism" or the idea of creative destruction.[19] This mentality probably explains why people at the time asked for the restoration of the gold standard at the prewar parity and not at the devalued parity. People knew, at least vaguely, that restoration of the gold standard at the prewar parity would necessitate macroeconomic tightening that might generate deflation. Nevertheless, people preferred the painful prewar parity to a painless devalued parity.

Thus, mistaken or preconceived ideas played a crucial role during the period of Japan's return to the gold standard. What appeared right to the public and to the popular news media was more influential in actual policy making than studied wisdom of experts. The result had serious consequences especially when the two ideas were contradictory. As the recent studies reveal the ideas of experts were in many cases more correct than those held by the common public who were amateurs in economics. It was the very existence of the cognitive gap between the experts and the public that obstructed the adoption of a desirable policy and kept the government maintaining the wrong policies for a long time. Indeed, restoration of the gold standard by many countries after WWI illustrated precisely the ramifications of the cognitive gap between experts' opinions and the common preconception.

V. Episode II: "Conventional Wisdom" or "Preconception" on Deflation

V-i. The Long Stagnating Japanese Economy under Deflation

About seventy years later, we see another good example that illustrates the cost of preconceived

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[19] Historically, the most famous phrase that properly defined the spirit of the liquidationism is the following statement by Andrew Mellon when he was the Secretary of the Treasury in the Hoover administration during the Great Depression: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. . . . Even a panic is not altogether a bad thing. It will purge the rottenness out of the system. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people." (Hoover, 1952, vol.3, p.30) Bradford DeLong (1997) pointed out that this kind of thinking could be also seen in the statements on the Great Depression by some famous economists such as Joseph Schumpeter, Friedrich Hayek, and Lionel Robbins. They maintained at the nadir of the Great Depression that the greatest danger the economy faced was inflation. Ralph Hawtrey said that it was the "equivalent of crying, 'Fire! Fire!' during Noah's flood." (Hawtrey, 1938, p.145)

ideas in the drama of policy responses toward deflation in Japan in the 2000s.

Japan's economy went through an unprecedented long period of deflation since the late 1990s. After the burst of the "bubble" economy in the beginning of 1990s, asset prices started to decline rapidly. Partly due to the appreciation of the yen, the CPI increase rate dropped to the negative range in 1995. Although the inflation rate did recover slightly for a short period of time from 1996 to 1997 (partly due to the increase caused by the hike of the consumption tax from three to five percent), the economic downswing in late 1997 put Japan's economy almost in a continuous state of deflation (Figure 1). A downslide in the consumer-price became so serious that the Bank of Japan (BOJ) decided to reduce the overnight call rate, the operational target of monetary policy, close to zero, which was called the zero interest rate policy. CPI declines and asset-price declines continued despite the zero interest rate policy, and in particular after the suspension of the zero interest policy in August 2000 that was decided after heated debates. Masaru Hayami, Governor of the BOJ who held the position for five years from March 1998, was succeeded by Toshihiko Fukui in March 2003. Since then, the downward trend of the CPI seems to have been moderated.

Under the expanding process of deflation, Japan's economic growth rate continued to stagnate. From 1992 to 1994, real growth rates of Japan's GDP were consistently below one percent. It eventually dropped to a negative range in 1998. At the same time, the jobless rate steadfastly increased in the early 1990s, rising from 2 percent in 1990 to 5.4 percent in 2003. In other words, Japan's deepening deflation was accompanied by the debilitation of the real economy, such as declines in the growth rate and increases in the jobless rate. "Japan's lost decade" depicts the situation quite accurately.

The causes for this long stagnation caused serious debate among numerous scholars and economists.[20] We hardly have room here to delve into the details of the debate. It is clear, however, that diminishing GDP growth rate and increasing jobless rate were strongly tied to continuing deflation during the period. Deflation was in turn closely associated with monetary contraction.

Japan's money supply as well as its monetary base increased dramatically during the bubble period of the late 1980s to the early 1990s (Figure 2). The increases in those two monetary

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[20] Numerous books that documented the controversies concerning possible causes and remedies for Japan's persistent stagnation were published since the deflation became aggravated in the 2000s. Representative of them are Iwata and Miyagawa (2003) and Hamada and Horiuchi (2004).

aggregates resulted from the persistent effort by the BOJ to maintain a low interest rate policy in order to prevent appreciation of the yen against the US dollar, which began after the so-called Plaza Accord in 1985. After Yasushi Mieno became Governor of the BOJ in 1989, the BOJ launched an aggressive policy to raise the interest rate to halt the bubble. As a result, the overnight call rate rose from 3 percent in 1989 to 8 percent in early 1991 (Figure 3).

The mass media applauded the initial phase of the BOJ's aggressive policy of monetary contraction led by Governor Mieno.[21] As can be seen in Figure 2, this tightening monetary policy after 1990 was causing a sharp decline in the money supply and monetary base from behind the scenes. Facing this situation, the BOJ decided to shift its policy from a tightening to an easing position in the spring of 1991. Since then, the BOJ gradually kept lowering its policy rate. Yet, in retrospect, the speed of easing money was far too slow to match the intensity of negative monetary shocks, which had taken the form of a sudden decline in money supply and monetary base. The inflation rate did not stop sliding downward despite the lowered policy rate. Because of the diminishing inflation rate, the BOJ had to continue to lower the policy rate. By the end of 1995, the policy rate had been lowered to an unparalleled 0.4 percent (Figure 3).

During this critical period of the early 1990s, there was a sharp division of opinions between the BOJ economists represented by Kunio Okina and some other economists, notably Kikuo Iwata, Seiji Shinpo, Takahiro Miyao, and Yutaka Harada, who criticized the BOJ's sluggish move toward monetary easing. In retrospect, those who criticized the BOJ seemed to have had far more valid points. Studies by Jinushi, Kuroki, and Miyao (2000), Ahearne et al. (2002), and McCallum (2001) coincidentally pointed out that the BOJ's reluctance in monetary easing from 1993 to 1994 was the immediate cause of Japan's prolonged deflation.[22] The reluctance of the BOJ to monetary easing appears even more problematic in light of the fact that Alan Greenspan, Chairman of the Federal Reserve, warned about the seriousness of the balance sheet problem in the private sectors after the burst of asset price bubbles (Truman, 2003, p.145).

The fact that the policy rate was approaching an extremely low level implied that the BOJ had

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[21] He was hailed as the *Onihei*, that is, a Sherlock Holmes equivalent hero in the Edo city, in modern times.

[22] Ahearne et al. (2002) say that "The 1993-94 period may have been particularly crucial for monetary policy, since that is the last time (with the exception of the short-lived response to the VAT hike in 1997) that inflation rates exceeded zero by a reasonable margin, so that a sufficiently large drop in the policy interest rate could have generated very low or negative short-term real interest rates. After the beginning of 1995, zero or negative inflation rates largely undermined the effectiveness of monetary policy by limiting the extent to which the real interest rate could be lowered." (Ahearne et al., 2002, p.13).

lost its conventional means to implement monetary policy. For a while, the expanding economic situation during 1996 and early 1997 obfuscated the problem. The seriousness of this problem became obvious in late 1997, when the economy returned to a serious situation once again, and the inflation rate slipped to below zero. In other words, Japan's economy was falling into a "deflationary trap."

In a situation where the policy rate has already hit or is hovering near the zero mark, the central bank cannot use its traditional instruments to cope with the problem. Consequently, deflation deepens further, and deflationary expectations intensify. Inevitably, one observes the increase in the real interest rate defined as the nominal rate minus the expected rate of inflation. The increase in the real rate of interest discourages consumer spending and corporate investment. Accordingly, shrinking total demand in the macro economy further worsens the deflation. Japan's economy after the end of 1990s was about to fall into this self-sustaining deflationary process.

Despite the deepening deflation, the BOJ, led by Masaru Hayami who was appointed Governor in March 1998, tended to indulge in a "wait-and-see" attitude toward deflation. There were some exceptions inside the BOJ. In particular, Nobuyuki Nakahara, a member of the monetary policy deliberation committee, advocated aggressive monetary easing policies. He was, however, never able to win the majority inside the BOJ board. The economy was already recovering from the recession in February 1999 when the BOJ decided to introduce the zero interest policy that the BOJ considered "abnormal." They were eagerly awaiting the departure from this "unusual" zero interest policy situation. In 2000, however, the BOJ leaders decided to raise the discount rate in order to depart from the zero interest policy, though deflation was still pervasive in Japan's economy. They were apparently afraid of losing the policy instrument of manipulating the interest rate as a part of the tradition policy measures. Harmful consequences from deflation were probably considered by the BOJ less serious than the loss of the interest rate control.

V-ii. Division of Opinions on Deflation and on Proper Policy Responses

The unusual situation in Japan's economy drew substantial attention from economists abroad as well as at home. Many ideas were presented concerning how to bring Japan's economy out of the "liquidity trap," the first case since the world economy endured the Great Depression. For instance, Krugman (1998), Bernanke (2000a), and Svensson (2001) were among those economists who expressed their ideas on the issue. Their arguments had significant influence on policy discussions in Japan, just as the arguments by Keynes, Fisher, and Cassel had affected the debate regarding Japan's return to the gold standard.

There were serious differences in opinions among Japanese economists concerning what was the best policy to implement in order for the Japanese economy to escape the deflationary trap under the zero interest rates. On one hand, some economists agreed with the arguments made by economists abroad. They advocated introduction of non-traditional monetary policy devices such as the inflation target, expansionary fiscal policy, exchange rate policy aimed to depreciate (at least resist the appreciation of) the yen, and or some combinations of these policies. On the other hand, there were economists who expressed their skepticism on taking further measures toward expansive macroeconomic policy and in particular, monetary policy. They claimed that there was no room left for exercising traditional policy measures to ease the credit since the financial system had become dysfunctional due to the accumulation of nonperforming loans. The government budget deficit had already reached the critical level. Therefore, they argued, one cannot expect much from macroeconomic policy.

For all those differences in such questions regarding the effective measures and the ways to implement them, a majority of academic economists seemed to share a basic agreement. That is, deflation is harmful to the economy and had to be overcome.

It has to be noted that this basic agreement on the harm of deflation only existed among experts, and that the agreement did not extend further to outside circles including the mass media. Indeed, the negative effect of deflation was seldom noticed outside scholarly circles, and the necessity to overcome deflation was rarely discussed. Instead, until the year 2002 or so, when deflation became more severe, popular discussions among journalistic circles were to identify "good deflation" and praise it. They explained the extent to which a deflationary economy benefits consumers through economizing distribution processes and more efficient methods of production, and the extent to which a deflationary economy could alter Japan's high cost structure. Deflation should be welcomed, according to them, since it is the result of great competition within a global economy. Naturally, in such an atmosphere, a majority of economists who advocated expansive monetary policy to breakaway from the deflationary economy were seen as promoting unhealthy inflationary policies. Those enemies of deflation were criticized and even teased by mass media.

This conventional wisdom or preconceived idea had a substantial effect on Japan's policy management. Despite the persistent and desperate warnings from a considerable number of economists about the danger of deflation, the government did not seem to recognize the importance of overcoming deflation and the implementation of a policy package against deflation until 2002. In that year, because of the progression of deflation, it became obvious for everyone that deflation had much to do with stagnating economy. Unfortunately, people had to go through the pain of deflation in order to break the spell of "good deflation."

Let us now turn to the role of mass media in this period. Deflation had hardly drawn serious attention from the mass media until it became serious in 2001. Figure 4 shows the change in the number of "hits" as a result of searching articles using a keyword "Defure (Deflation)" in the database of Nikkei Telecom that counts the number of articles of nationwide newspapers (*Asahi*, *Mainichi*, *Yomiuri*, *Sankei*, and *Nikkei*). Other than 1995 and 1998 when the inflation rate dropped to a negative range due to a weak economy, deflation was rarely discussed in nationwide newspapers before 2001, when the cost of deflationary economy became really serious.

The same tendency can be found for the frequency in the media's attention on the government's policy formation. Figure 5 shows similar statistics using two different keywords "Kozo Kaikaku (Structural Reform)" and "Defure Taisaku (Policy Measures against Deflation)." From the spring to the summer of 2001, "structural reform" received huge attention from the media. These data reflect the course of events that in April of 2001 Junichiro Koizumi became the Prime Minister of Japan and that "pain enduring structural reform," the mantra of the cabinet, became a popular headline for newspapers. Enthusiastic media coverage of this mantra did not last long, however. In 2002, "policy measures against deflation" became another important mantra for the government. Especially, after the government introduced the "Comprehensive Policy Package against Deflation" in October 2002, the number of hits regarding this slogan exceeded that of "Structural Reform."

Not only the news media but also the government shifted its policy emphasis. This can be confirmed by tracing the summary of the debates within the Council of Economic and Fiscal Policy (CEFP). The CEFP is a "collegiate organization set up in the Cabinet Office in January, 2001 with the aim of strengthening the Prime Minister's political leadership in the matter of economic and fiscal policies." This council is considered to be a crucial organization for setting the basic goals of Japan's economic policy. The members of the council are the Prime Minister, the ministers of economic ministries, the Governor of the BOJ, and four other members from the private sector. On the list of the titles for agenda items of the Council meetings (http://www.keizai-shimon.go.jp/minutes/index.html), the word "Defure (Deflation)" came up only once in 2001. But, the frequency increased to six times in the titles in 2002 and became one of the most important policy agendas. The conference summaries of CEFP also confirm the shift in policy agenda.[23]

There could be some differences in opinions among viewers in interpreting how much the government's shift in its policy stance did in fact affect the actual policy outcomes, and, more importantly, how much the changes in media opinions affected government policy stances. Further research should address this question. For the present, we tentatively argue that the shift in conventional wisdom or preoccupation with deflation among the public media was the prerequisite for the shift in government's policy stance. In the next section, we will elaborate on this point by tracing the opinions of newspaper editorials during this most critical period of the Japanese economy, from the year 2000 to 2003.

V-iii. The Trend in Editorial Opinions in Major Newspapers on the Issue of Deflation

In the following, we survey the trend of editorial opinions in three Japanese newspapers, the *Asahi*, the *Mainichi* and the *Yomiuri*, from year 2000 to 2003. The circulation numbers of morning editions of these three major newspapers from January to June of 2004 were *Yomiuri* 10,075,479, *Asahi* 8,259,173, and *Mainichi* 3,956,348. Distribution rate per household of each of the three major newspapers adds up to 44.47 percent; *Yomiuri* 20.13 percent, *Asahi* 16.45 percent, and *Mainichi* 7.89 percent.[24]

Table 1 shows the result of counting the number of editorial articles from 2000 to 2003 that contain the word "Defure (Deflation)." The *Yomiuri* has mentioned the word far more times than the other two. The persistence of the *Yomiuri* in mentioning deflation was quite distinct.[25] *Mainichi*'s "pro-deflation" editorials expressed the opposite side of those in the *Yomiuri*. In fact, both sides criticized BOJ's policy implementation under Governor Hayami severely, although from the mutually opposite directions.

Among three major newspapers, the *Asahi* spoke for the average view of the media. The basic

[23] As Hamada (2004) shows, the initial atmosphere of CEFP was apparently influenced by "good deflation" theory. Thanks to ardent persuasion by some scholars, however, the atmosphere among the members of CEFP gradually changed as days (months or years) went by.
[24] These figures are from the "Newspaper Publishers Report" published by Japan Audit Bureau of Circulations (JABC).
[25] In assessing the effectiveness of the opinions of the *Yomiuri*, it should be remembered that the *Yomiuri's* views were reputed to have reflected the personal views of its quite individualistic owner, Tsuneo Watanabe.

tone of *Asahi*'s editorials until the early half of 2001 was similar to the "advocating the good deflation" view that appeared in the *Mainichi*. However, the argument gradually disappeared over time as deflation progressed. The *Asahi* started to advocate the necessity of overcoming deflationary economy at the beginning of 2003. Still, it kept opposing the adoption of a quantitative easing policy or the inflation target. In the end of 2003, *Asahi* altered its view drastically by publishing an editorial favorable to the BOJ's quantitative easing policy. *Asahi*'s change in the direction of its editorials was with the policy shift of the emphasis of the government from "Structural Reform" to "Against Deflation."

We will examine editorial articles of these three major newspapers by dividing the period into several sub-periods.[26]

(1) Until the end of zero interest policy: 2000-August 2000

Japan's economy was mildly recovering in early 2000 although deflation did not show any sign of rebounding. The BOJ, which adopted the zero interest policy in February 1999, had announced that it would continue the zero interest policy until "concerns for deflation" would disappear. Nevertheless, the BOJ never defined what was meant by "concerns for deflation," and this ambiguity in the wording for the conditions for discontinuing the zero interest policy generated active controversies regarding whether and when the zero interest policy should be discontinued. The debates continued until August 2000 when the BOJ actually decided to halt the zero interest policy.

The tone of the media during this time period is well represented by the following *Asahi*'s editorial.

> "Editorial: Central bank must restore rational monetary policy," *Asahi*, 2/4/2000.
> The central bank's Hayami has repeatedly said that the zero-interest policy will stand until the danger of deflation has dropped below the horizon. But such a condition is too abstract. It is necessary to have a clear, generally understandable standard for lifting the zero-interest rate policy. When an exceptional situation persists long enough, it is no longer clear what is exceptional. That is dangerous. . . . Business borrowers presented with a lighter interest burden could be lulled into a false sense of security that could lead them to put off needed reorganization. That is true not only of business but government reorganization as well.

[26] Most of the following editorial sentences were retrieved from a full text database LexisNexis Academic. The rest were from G-Search Classic.

> The most obvious hazard of a zero-interest policy is a loss of discipline in public finance. If there were no reason to be concerned about the cost of interest payments swelling even with the issuance of new government bonding, there would be no incentive to restrain such new issues. . . . By helping the government with massive bond issues, the Bank of Japan actually enhances a lack of fiscal discipline in government.

An editorial by the *Yomiuri*, on the other hand, presented a contrasting view. The *Yomiuri* was the only media to give a favorable view to the introduction of the “inflation target,” which a small number of officials in the government started to consider its possible adoption.

> "Editorial: A further argument for the inflation target is needed," *Yomiurii*, 2/5/2000.
> The Liberal Democratic Party plans to consider the feasibility of setting a so-called inflation target, a target for increases in commodity prices, and measures to achieve the target. . . . One year has passed since the Bank of Japan introduced zero-interest policies. . . . the economy has yet to be put on a path to self-sustaining recovery led by private demand. To make sure that the economy recovers, it is necessary to implement more easy-money policies to increase the quantity of money in the market. A specific target set for the rise of commodity prices would act as a yardstick in carrying out such steps and would be effective in dispelling anxiety about deflation.

The *Mainichi* was even more critical against the expansive macro economic policy than the *Asahi*, and kept presenting its “pro-deflation” view.

> "Editorial: A year of near-zero interest rates. We need to hike it," *Mainichi*, 2/10/2000.
> Almost a year has gone by since the Bank of Japan implemented an unprecedented policy of maintaining interests rates at levels near zero. Ultra-low interest rates have provided financial institutions with breathing room and allowed the economy to rebound and prices to stabilize. The public, on the other hand, has grown accustomed to savings accounts that pay almost no interest. As a result, they no longer seem to find the energy to complain. . . . The central bank says it will raise the interest rate as soon as deflationary trends have been eliminated. But such a move would be a mistake. Instead, the Bank of Japan should immediately abandon its near-zero interest rate policy and quickly return the official discount rate to normal levels. . . . The Bank of Japan's policy of pushing the interest rate toward zero has been a fiasco. It is impossible to use the interest rate as a policy tool when it begins to approximate zero.

Under pressure from the media to discontinue the zero interest policy, the BOJ started to pave the way to actually lift the policy. In July 2000, the end of the zero interest policy was expected to be announced any time. But, *Sogo*, one of Japan's largest department stores, unexpectedly went into bankruptcy, and this incident prevented the BOJ from implementing its policy shift in July. Following editorials of *Asahi*, *Mainichi* and *Yomiuri* are their reactions to the event, which show opposite stances between *Asahi-Mainichi* and *Yomiuri* to the BOJ's decision to the policy shift.

"Editorial: Central bank's zero-rate policy hints at political interference," *Asahi*, 7/18/2000.
We have argued that the zero-interest policy, which was supposed to have been an inescapable emergency measure, should be corrected soon. The policy of supplying abundant money to keep the overnight interest rate at zero in the short-term money market led both business firms and financial institutions to lose their sense of crisis. They postponed attempts to pick up the pieces left by the bursting of the economic bubble. By delaying the settlement of its problems, Sogo ended up festering. The extraordinary interest rate policy, it can be said, has contributed to such a corporate failure. Supporters of the zero-interest policy are worried that higher interest rates would harm the construction and distribution industries, as well as small- and medium-sized credit institutions. However, they should attach greater importance to the fact that an indefinite continuation of the zero-interest policy delays recovery and improvement of their health.

"Editorial: Is the BOJ spineless?," *Mainichi*, 7/18/2000.
The central bank said that the potential fallout from the bankruptcy of Sogo Co., the department store chain, precluded it from raising interest rates at this time. A central bank that chooses to base its monetary policy on the fate of a single corporation is making a grave error, however. An amendment to the Bank of Japan Law was supposed to have bolstered the central bank's independence, but it continues to be concerned about the opinions of Japanese politicians and U.S. officials. Does the central bank have a spine? The nation's economy will undergo major upheavals as it heads into the 21st century, and will eventually have to implement the structural reforms that were postponed throughout the "lost decade" of the 1990s. The tendency to procrastinate was encouraged by the central bank's ultra low interest rate policy. Structural reforms cannot be implemented without a normal monetary policy.

"Editorial: BOJ should keep zero-rate policy," *Yomiuri*, 7/18/2000.
Depending on the outcome of the Sogo case, there is a strong possibility that a self-sustaining economic recovery led by private demand will be further delayed. . . . To begin

with, we cannot find any reason to hastily end the zero-interest-rate policy. There is an opinion that maintaining the zero-rate policy may bring about moral hazard on the part of companies who depend on the policy and, as a result, painful but necessary corporate restructuring will be postponed. However, even if the ultra-easy monetary policy were to be lifted, the target of the short-term interest rate would be raised by about 0.25 percentage point. . . . The theory that corporate management tends to act irresponsibly when interest rates are near zero but responsibly when rates stand at 0.25 percent does not stand up to examination.

On August 11th of 2000, the BOJ eventually decided to suspend the zero interest policy despite the opposition of the government. Following contrasting views were the reactions to this reckless (according to our view) decision by the BOJ.

"Editorial: Welcome decision to end zero-interest-rate policy," *Asahi*, 8/12/2000.
Governor Masaru Hayami said: Maintaining a zero-interest-rate policy indefinitely will result in the economy losing vitality, and thus adversely affect its recovery. The governor is right. We have argued that the policy should be brought to an end as early as possible because it was a stopgap measure implemented in response to an emergency. We support the latest decision of the BOJ's Policy Board.

"Editorial: Interest-rate hike. Only a step toward a normality," *Mainichi*, 8/12/2000.
The Bank of Japan had allowed the zero-interest-rate policy to remain intact for so long. It was introduced in February 1999 as an ad hoc measure to effectively shield the central bank from having to purchase deficit-covering bonds. Even if the ultra-low rates helped slow deflation, they should have been raised back up immediately. The September 1998 lowering of the overnight call rate from 0.5 percent to 0.25 percent was itself an emergency step. Moving it back up to 0.25 percent still leaves the nation with historically low interest rates. Because the near-zero rate policy had been in place for so long, the government and many private firms had begun to accept it as normal. The Bank of Japan has only itself to blame for allowing the mood to become so widespread. . . . The latest move by the Bank of Japan is not sufficient, of course, to normalize the financial sector. Savings accounts, for example, would still earn next to nothing. This is but the first of many more steps the central bank must take; its next should be to bring overnight interbank rates back to at least 0.5 percent.

"Editorial: BOJ must win public confidence," *Yomiuri*, 8/12/2000.

The Bank of Japan decided Friday to end its zero-interest-rate policy as it believes the economy has reached a stage "at which deflationary concerns have been dispelled," which was its stated condition for lifting the policy. Doubts remain, however, about whether the decision was appropriate. This is because consumption, a key driving force of the economy, has still not picked up steam, and the downward trend in consumer prices has yet to be halted. . . . Can companies whose management has sunk beyond hope be made to leave the stage without repercussions? It is necessary to tread carefully for the time being in the struggle to bring about an economic recovery. Ending the zero-rate policy should not be allowed to become a new destabilizing factor. . . . It is essential for the central bank to declare to the public, as well as the domestic and foreign markets, that it will continue its easy-money policy even when the zero-rate policy ends to secure an adequate money supply, and that it will not raise rates again for now.

(2) Resumption of the zero interest policy and introduction of quantitative easing: from September 2000 - March 2001

After the BOJ suspended the zero interest policy, partly due to the worldwide economic slowdown, Japan's domestic economy started declining again, and indicators of deflation became more serious. Under the circumstances, policy discussions focused on the policy instruments such as the introduction of an inflation target, and the fight against deflation through depreciation of the yen resurfaced. The *Mainichi* and the *Asahi* expressed their critical opinions concerning these policy measures.

"Editorial: Inflation targeting is the wrong way round," *Mainichi*, 10/29/2000.
The Bank of Japan has dug in its heels, rebuffing pressure from the Liberal Democratic Party and economists to adopt inflation targets in order to stem deflation caused by insufficient demand. The most important task of a central bank is to maintain the value of the currency, and price stability is essential for carrying out this task. . . . It is important to realize that much of the price declines can be attributed to deregulation. . . . And once inflation is triggered, it is difficult to bring under control. Central banks can establish various policies to stabilize prices but cannot manipulate prices in accordance with their whim. And once inflation gets underway, it rapidly devalues assets held by citizens. Central bankers have an obligation to prevent this from happening. It was only 10 years ago that Japan underwent a period of abnormally steep asset inflation. Why are people already clamoring for a new round of inflation?

"Editorial: Bank of Japan should resist external pressure on its policy," *Asahi*,11/1/2000.

The Bank of Japan, taking pride in its role as the guardian of the value of the yen, has a basic philosophy of encouraging price stability, and it cannot -and should not- assume a policy of devaluing the yen. Experience has shown that once inflation runs free, it cannot be controlled easily. The bank was right to ignore calls to purposely trigger inflation.

When deflation was deepening, and recession was becoming obvious to the public, the government decided to change the definition of “deflation” in order to make the definition conform to the universal use of the term. The government rephrased it from “an economic slowdown accompanied by decline in prices” to “a continuous downward trend in prices.”[27] Then, it went on to admit publicly for the first time since the end of WWII as follows: “The current state of Japan’s economy is in mild deflation.” The following editorial pieces show the contrasting views of the *Mainichi* and the *Yomiuri* on this matter.

"Editorial: Proclamation of being in deflation. Don’t stop the decline of prices," *Mainichi*, 3/17/2001.

The government's monthly economic report issued on Friday acknowledged that the economy is in a state of deflation. The continuing decline in consumer and wholesale prices, in other words, has been construed as being undesirable. The drop, though, is largely the result of burgeoning imports, technological advances and the streamlining of distribution. Even services, long considered too costly compared to other countries, have been getting cheaper. The economy is shifting to a new pricing structure due to globalization and deregulation. The declaration of deflation was accompanied by a new definition of the term as "a state in which prices keep falling," deviating from the previous official description as "a state in which prices are falling while the economy is receding." Apparently it is a disguised demand to the Bank of Japan for further quantitative easing. It is an admission of the dearth of economic policy options left at the administration's disposal. There is no need to prop up prices; they should be allowed to drop further.

"Editorial: Government in economic never-never land," *Yomiuri*, 3/17/2001.

On Friday, the government revised its definition of deflation. It officially recognized that the Japanese economy is in a state of deflation. The erstwhile government view that Japan

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[27] One of the authors remembers that Kazumasa Iwata, Director General at that time, called him to tell him about the change in the definition of deflation in conforming to the world standard and conforming to the logic he used in his policy writing.

was not in a state of deflation did not convince the general public, even as a deflationary spiral --a maelstrom of falling prices and recession that represents a malignant, advanced form of deflation-- was growing increasingly visible. The government can take a kudos for its revision of the definition of deflation and its recognition that deflation is happening in Japan --for now at least-- as actions that provide an accurate grasp of reality of the domestic economy. . . . Recognition of deflation is meaningless unless actual policies reflect the sense of crisis. The introduction of "an inflation target rate" is one measure likely to be effective in braking the price plunges that consequently contract production and consumption activities.

Under the circumstances, on March 19th, the BOJ decided to re-implement the de facto zero interest policy by putting a quantitative easing policy into effect. This BOJ's policy shift is reflected in the following editorials.

"Editorial: BOJ goes back to zero, Monetary easing can't be a substitute for structural reform," *Mainichi*, 3/20/2001.
On Mar. 19, the Bank of Japan's (BOJ) Policy Board reinstated what is effectively a zero interest rate policy (ZIRP). . . . Is the central bank attempting to enter into a "dialogue with the marketplace" a la Alan Greenspan, or are its actions directed at politicians? The Bank of Japan has decided to pursue a policy of monetary easing until the consumer price index stabilizes. In essence, the central bank has adopted the policy of inflation targeting that it had opposed until now. The BOJ also stated that it would step up its purchases of long-term government bonds. . . . The Bank of Japan should be warned that its decision to embark on a policy of quantitative easing is risky because its purchases of government bonds could eventually lead it into a "monetary hell" where it is forced to become an underwriter of the same debt. . . . It is important to realize, however, that increasing the money supply will neither ease the pain of structural reform nor take its place.

"Editorial: Make best use of BOJ's decision," *Yomiuri*, 3/20/2001.
Since the central bank lifted its zero-rate policy in August, it had consistently asserted that there was no need for it to reinstate the policy nor for it to relax monetary policy in a quantitative manner. The Bank of Japan has performed an about-face because a situation has developed in which the Japanese economy may fall into a deflationary spiral that could trigger massive turmoil in the world economy. To avert the risk of a deflationary spiral --a chain reaction of falling prices and recession-- the government must take full advantage of the central bank's decision. . . . The Bank of Japan has learned a bitter lesson. It rejected a

government request that it postpone an interest-rate hike on the grounds that it would be premature to do so and went ahead with the suspension of the zero-rate policy. But only seven months later, it has been compelled to implement an unprecedented easing of its monetary stance. The latest decision by the central bank may be interpreted as a shift in its monetary policy made in line with changes that took place after the suspension of the zero-rate policy, such as the sharp slowdown of the U.S. economy.

(3) The period of gradual quantitative credit easing policy: from 2001 to January 2003

The implementation of quantitative easing policy by the BOJ raised the question of the responsibility of Governor Hayami, who dared to terminate the zero interest policy in spite of the government's opposition in August 2000. The media reported in April of 2001 that Governor Hayami was considering his resignation. The following articles from *Yomiuri* and *Mainichi* both criticize governor Hayami on the issue, but, interestingly enough, from the reasons that are completely opposite.

"Editorial: Hayami's mixed legacy at BOJ," *Yomiuri*, 4/28/2001.
The public has been well aware of what has taken place since last August, when Hayami took the initiative in ending the central bank's zero-interest policy despite strong objections from the government and the ruling parties. What ensued by a renewed economic slump in the economy. Faced with a serious deflationary crisis, the Bank of Japan brought its zero-interest policy back in place in March. Undoubtedly, the central bank proved itself to be an "independent" body under the new Bank of Japan Law when it forced the step of ending its zero-interest policy. However, the public and the market were disappointed that the bank just looked on without doing anything to contain the deflationary crisis. Rather, the bank was filled with a groundless fear that inflation could strike the nation. The nation's deflationary crisis is serious, as shown by a record 0.4 percent plunge in the consumer price index for fiscal 2000. In this sense, Hayami bears a heavy responsibility for his erroneous decisions about what was good for the economy.

"Editorial: Hayami's waffling," *Mainichi*, 5/24/2001.
In monetary policy, results count for everything. When the central bank adopted its policy of near-zero percent interest rates in February 1999, it explained the step as an emergency response to a financial system crisis. But on March 19 this year, the bank reverted to a policy of quantitative easing and hence rates approaching zero percent. Both short- and long-term interest rates have declined since then, but in spite of signs of a glut of funds in

the short-term financial markets, corporate activity has not picked up. . . . Some reports indicate that Hayami decided to stay on because he thinks highly of Prime Minister Junichiro Koizumi's reform program. But if the central bank continues to base its monetary policy on quantitative easing, it will simply delay painful structural reforms and hinder the weeding out of weaker industries. Hayami's denials notwithstanding, if rumors of his resignation persist, the market will turn its back on him. He bears a personal responsibility to take steps ensuring that monetary policy returns to a state of normalcy as quickly as possible.

Governor Hayami's responsibility issue was obscured by the advent of the Koizumi Cabinet that set forth structural reform as its policy priority. Then, the topic of structural reform attracted an unprecedented fever from the domestic news media. Despite the fever on structural reform in the media, the economic condition worsened. On August 14th, the first time since the BOJ had adopted the quantitative credit easing policy in March, the BOJ strengthened its credit easing measure.

"Editorial: Steps should not be last," *Yomiurii*, 8/16/2001.
The Bank of Japan explained the latest steps as measures to strengthen the foundations for economic recovery and to support the government's structural reform. In reality, the latest central bank measures came from a strong sense of crisis on the part of the government and the ruling parties as well as the recent plunge of the stock market. A series of recent monetary easing policies by the central bank, including the latest ones, inevitably leads one to imagine they are only minimal bit-by-bit steps. The Bank of Japan has to show a strong determination to fight deflation, and must make utmost efforts in that direction as the nation's central bank.

Since then, as deflation and depression continued to worsen, the BOJ was obliged to strengthen the quantitative easing measure little by little and step by step. The situation did not improve in spite of the BOJ's effort, and again, the question of whether to adopt the inflation target measure became a subject of debate.

"Editorial: Inflation is no cure-all," *Mainichi*, 1/26/2002.
There are no proven formulas to fight deflation, however, and the Bank of Japan has already reached its limit on what it can do from the monetary side. This has prompted many to urge the central bank to announce a target for the rate of inflation and utilize all policy measures at its disposal to achieve such a target. Expectations of higher prices in the future would, it

> is reasoned, compel investors and consumers to spend more. Indeed, the BOJ decided last March to maintain its lax monetary policy until prices at least stopped falling. It has since been pouring money into commercial banks to trigger spending. There is nothing more it can realistically do. It is not possible, moreover, to willfully steer the exchange rate lower in order to boost Japan's exports and induce higher prices domestically. The exchange rate is determined by economic fundamentals, and tampering with it, as U.S. Treasury Secretary Paul O'Neill recently noted, can only weaken one's own economy. Instead of fighting it, the declining prices should be regarded as good news for consumers, and ways to boost demand should accordingly be considered. . . . The government should focus on achieving a soft-landing to a new pricing structure and express a positive vision for the future, such as by boldly shifting budgetary appropriations around and encouraging companies and individuals to increase spending.

Asahi's line of argument was consistently critical of the inflation target, as similar to *Mainichi*'s. Nevertheless, *Asahi*'s tone was changing over time. The *Asahi* no longer advocated the "good deflation" theory.

> "Editorial: Everyone must cooperate in the renewed effort," *Asahi*, 1/6/2003.
> We do not disagree with those who say that mild inflation in the course of pulling the economy out of deflation would not be a bad thing. The problem is how that can be achieved. There is no specific or sure cure. If the Bank of Japan were to buy up corporate shares and properties without restraint, the result could be inflation. Such an approach, however, would not only worsen the financial position of the central bank, but would diminish public trust in the economy, leading to a plunge in the price of government bonds. There is also a danger that the result would be runaway inflation. And if that happened, much of the value of what people have worked so hard to put into savings would be lost. Similar results could come from application of a policy that promotes inflation by diminishing the value of the yen.

Another political focus during the end of 2002 to the early 2003 was about who would be the next Governor of the BOJ after Governor Hayami, who was to retire in March 2003. Prime Minister Koizumi, in December of 2003, expressed his opinion on the criteria for the selection of the next Governor of the BOJ. The Prime Minister said "the one who possesses a strong will to overcome deflation is most desirable." After the Prime Minister's remark, Nobuyuki Nakahara, a former member of the BOJ Policy Board and an advocate of inflation target, was rumored to surface as a potential candidate for the next Governor of the BOJ. In a January 17, 2003 an editorial titled “The nomination of new BOJ Governor: stupidity of hoping for ‘pro-inflation governor’,” *Mainichi* made a harsh opposition to it.

(4) The selection of the new governor, and the aftermath: From February 2003 to December 2003

The government eventually selected Toshihiko Fukui, the former vice-governor of the BOJ, as the new Governor of the BOJ in February 2003.

> "Editorial: He needs to keep politicians at an arm's length," *Asahi*, 2/25/2003.
> Some politicians and academics continue to believe, if not so outspoken about it now, that a price-increase targeting policy would be the miracle cure. Some politicians, impatient that the central bank has not fallen under their sway, have even tried to again amend the Bank of Japan Law, which just a few years ago was fortified to give the central bank greater independence. If the central bank were to sacrifice credibility now as a result of politicians in pursuit of immediate benefit, the value of the yen would sink, exacting a severe toll on people's daily lives. While the government and the Bank of Japan should naturally cooperate in the fight against deflation, the nation's economic woes cannot be solved by having the government try to force the central bank to do with monetary policy what the government itself has not been able to do with fiscal policy.

> "Editorial: Restoring trust in the Bank of Japan," *Mainichi*, 2/25/2003.
> The nomination of a successor to Hayami has attracted a high degree of attention because of expectations that the next BOJ chief will help lead the economy out of its current slump. Prime Minister Junichiro Koizumi has stated that the head of the central bank should have a zeal for fighting deflation. Unfortunately, since the latter half of the 1990s, the BOJ's policies of near zero interest rates and quantitative easing have left its reputation in tatters, and the entire Japanese economy under a dark cloud. As the watchman of the currency, Fukui will be expected to steer monetary policy while refusing to cave in to politicians and the Cabinet, asserting the independence of the central bank called for in the new Bank of Japan Law.

> "Editorial: Fukui must try a new tack," *Yomiuri*, 2/25/2003.
> Fukui, currently chairman of the Fujitsu Research Institute, a private think tank, will be expected to drag the Japanese economy, which is on the verge of crisis, out of deflation. If he is to do so, he will have to chart a new course for the central bank, departing from its

traditional policies. We urge Fukui to listen carefully to the opinions of his new deputy governors --former Vice Finance Minister Toshiro Muto and Kazumasa Iwata, director general for policy planning at the Cabinet Office-- and launch a counterattack on deflation by mobilizing unconventional policies. According to Article 2 of the Bank of Japan Law, the central bank's main mission is to stabilize prices. Thus, the central bank chief is tasked with fighting not only inflation but also deflation. . . . The nation's economic situation has deteriorated to such an extent that the central bank can no longer stand on the sidelines and say "the Bank of Japan alone cannot stop deflation."

Before Fukui became the Governor of the BOJ, he was regarded as a candidate who would be as reluctant to ease the credit as was the former Governor. On the contrary, Fukui put a policy stance of aggressive monetary easing into effect right after he became the Governor. In addition, the BOJ under Fukui's direction cooperated with Ministry of Finance in supporting numerous exchange rate interventions that intended to minimize the abrupt appreciation of the yen in the fall of 2003. The BOJ implemented the expansion of quantitative easing, in order to assure that exchange market interventions would be *de facto* unsterilized interventions.[28] A following editorial is the comment from the *Asahi*, which shows a clear shift in its tone.

"Editorial: Defeating deflation: The new cabinet has a big homework assignment," *Asahi*, 11/16/2003.

The defeat of deflation is imperative to attain this economic goal. Although prices have come down, there has been no similar drop in the amount of debt that must be repaid. This situation naturally intensifies the burden on companies and individuals who have taken out loans. . . . Under the zero-interest deflation" existing in Japan today, real interest rates level off high. These factors inevitably act to curb personal consumption and capital investment. Prime Minister Junichiro Koizumi's new Cabinet, set to be inaugurated this week, will thus

[28] Edwin Truman contends that calling for unsterilized foreign exchange-market purchases of dollars for the BOJ is meaningless since the BOJ's decision to undertake monetary policy and the decision of the MOF (Ministry of Finance) to make purchases of dollars are institutionally separated. According to him, intervening operations in Japan are by definition sterilized since they are conducted under the aegis of the MOF within its balance sheet, thus having no impact on the BOJ's balance sheet (Truman, 2003, p.152). We admit that intervening operations would be automatically sterilized as long as the BOJ kept its monetary target unchanged regardless of the intervention. Once the intervention operations are followed by simultaneous changes of the monetary target on the side of BOJ, however, they become virtually unsterilized interventions since both the MOF's and the BOJ's balance sheets must change together in pace. It is what happened, at least partially, during the period when massive intervening operations were conducted and the target of current account balances at the BOJ were increased at the same time from October 2003 to January 2004. The same interpretation can be seen in Greenspan (2004).

> face this demanding homework assignment of coming to grips with Japan's deflationary spiral. The present focus of deflation-fighting measures is quantitative financial deregulation -in other words, an ultra- easy monetary policy. . . . The recent appreciation of the yen on foreign exchange markets is also bad news for an economic recovery. When the stronger yen is factored into the equation, the stress being placed on pumping money into the economy is understandable.

The *Mainichi* never abandoned the "good deflation" theory, and kept calling for the termination of zero interest policy.

V-iv. Meaning of Conventional Wisdom on Deflation

As already stated, the Japanese government placed its priority on "conquering deflation" as high as structural reform among its policy agenda. Under such a political environment, the government appointed three new members to the executive office of the BOJ headed by Governor Toshihiko Fukui.[29] Because of the BOJ's reluctance to ease money under the direction of governor Hayami, the BOJ often disagreed with the government. This new executive office that started in March 2003 was successful in giving a strong impression to the outside world that the BOJ shared the same goal with the government in implementing aggressive monetary easing measure by itself.[30] Helped as well by the recovery of the world

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[29] Two deputy governors are Toshiro Muto, a former administrative vice-minister of the Ministry of Finance, and Kazumasa Iwata, a Director-General for Policy Planning of the Cabinet Office and a former professor of Tokyo University.

[30] When the government selected Fukui as a new governor of BOJ, he was not welcomed by the foreign media. Fukui was perceived by many as a successor of Hayami, a former governor of BOJ who was extremely careful and even reluctant to monetary policy management during his governorship. For an example, in an article "Japan's Great Hope (Aug.4, 2001)", *the Economist* recommended Prime Minister Koizumi to fire governor Hayami by accusing him of being a lame governor who cannot or will not deal with deflation. Moreover, when Prime Minister Koizumi chose Fukui as the next governor, this time *the Economist* turned to PM and criticized his decision. In "Muddleheart Koizumi (Feb.27, 2003)", *the Economist*, with harsh criticism, wrote "What Mr. Koizumi lost by this appointment was the chance to show that he really does want novelty, that he truly wants to change Japan." However, almost a year after the critical article appeared in *the Economist*, the magazine praised Fukui by calling him "the world's best central banker" in its article "the Bank of Japan Thoshihiko Goldilocks (Feb.12, 2004)." It went on to criticize Masaru Hayami, a former governor of BOJ, by calling him a "possibly the world's worst central banker" who profess there is nothing BOJ can do while the interest is zero. Fukui, on the other hand, is clearly committed to aggressively pursue a quantitative easing policy until the inflationary economy is actually achieved. On this regard, Fukui has adjusted the BOJ's monetary policy to the right course, and *the Economist* recognized him as a better central banker than Alan Greenspan at America's Federal Reserve or Jean-Claude Trichet at the European Central Bank.

economy, the seriousness of Japan's deflation started declining gradually.

Although there were differences in the detail, the history of Japan's deflation and the policy responses of the government in the 1990s resemble those of Japan's Showa Depression. In both the Showa Depression and the current depression, the deterioration of the actual economic environment forced the government to shift its policy. In other words, the implementation of necessary policy measures was constantly postponed and prevented because of preconceived ideas until there was a crisis or near crisis. For example, the newspapers, based upon the "good deflation" theory, often encouraged the BOJ to lift its zero interest policy and criticized the government's effort to persuade the BOJ to ease money.

The "good deflation" theory, that was popular among the media, had four propositions.

1. Deflation is a good phenomenon.
2. Deflation is not a monetary phenomenon but a structural, that is, microeconomic phenomenon.
3. The causes of current deflation are globalization, deregulation, and technological innovation.
4. Depreciation of the yen harms both Japan and the rest of the world.

It is obvious that all of these arguments are hardly accepted by the modern school of macroeconomics. Concerning the first proposition, economists do think that the changes in nominal variables such as deflation and inflation may be neutral to the real economy in the "long run." As long as the rigidity in nominal variables remains, however, the changes in absolute prices will affect the real variables. Therefore, if the nominal adjustment is inadequate, the deflation can function as a primary cause to keep the economy below its potential level in the short run. Whatever the case may be, deflation is not a "good" thing for the real economy.[31] The "good deflation" theory simply confuses the absolute price change of goods and services with the relative price depreciations of a certain commodity due to innovation.

The second and the third propositions are the core of good deflation theory. The question here is not whether or not real factors might affect the prices or not. As the identity equation of the

[31] If there is an economic theory that can justify deflation, that might be a Milton Friedman's "optimal rate of inflation" concept (Friedman, 1969). Since this optimal rate is given by a negative of real interest rate, an optimal inflation rate becomes negative as long as a real interest rate of an economy stays positive. Friedman argued that this negative interest rate is ideal because households enjoy maximum consumer surplus in money holding. However, as Woodford (2003, ch.7) argues, this kind of reasoning only works in a world in which nominal rigidities does not exist. That means this kind of world only exists in a hypothetical world. In fact, no single central bank in the world has set its goal for negative inflation rate based on this Friedman's rule.

quantity theory of money tells, if a quantity of money is constant, an increase in real income inevitably results in deflation. Moreover, the analysis of aggregate demand and aggregate supply in a macroeconomics textbook shows that the "positive supply shocks" such as a price reduction of traded goods and a technical innovation would, by making a supply curve shift rightward, lead to a reduction of the general prices. There is no error in the analysis itself. The problem of good deflation theory rests in the fact that it claims, beyond this kind of analysis, that monetary factors cannot affect the general price level. This claim is clearly wrong, since the absolute prices, or the general price level, are the prices of a currency relative to the goods and services. Therefore, the prices definitely depend on the supply of money.

The good deflation theory also tries to tell us that the deflation caused by a positive supply shock is good. This contention is also wrong. It is no doubt that a positive supply shock itself is a favorable phenomenon that would increase the real income. It does not follow, however, that the deflation caused by the positive supply shock is also favorable. It is always possible to prevent deflation with monetary policies even though a positive supply shock occurs. In general, a combination of the rise in the potential growth rate that might be induced by positive supply shocks and adequate monetary policy implementation that might prevent these shocks from leading to an excessive disinflation or a deflation, allows actual growth rate to be heightened to the most desirable level. The U.S. economy during 1990s called the "fabulous decade" (Blinder and Yellen, 2001) might be a typical example that shows a successful result of this combination.

The problem with the fourth proposition is that it neglects the fact that Japan is under a floating exchange rate system, and under that system, the exchange rate is an endogenous variable determined by a variety of macroeconomic variables. According to the classical open economy model, the nominal exchange rate is determined mostly by monetary factors. The influence of nominal factors on the real economy is completely neutral there. In a Keynesian type of open economy model, such as the Mundell-Fleming Model, the depreciation of a nominal exchange rate of one's own currency caused by a monetary expansion will increases the external demand by depreciating the real exchange rate. The advocates of the "good deflation" theory often define the phenomenon as if it were a beggar-thy-neighbor policy. This perspective is incorrect. Under the floating exchange rate system, in which each country maintains the autonomy of monetary policy, each country retains the freedom to implement similar measure of its own. With monetary policy autonomy, each country can easily minimize the negative effects imposed by the depreciation of the exchange rate of another country's currency. This process is mutually growth promotional, thus nothing to do with a beggar-thy-neighbor policy.[32]

A small number of Japanese economists continued to maintain the fallacy of the "good deflation" theory.[33] It is not clear, however, whether their efforts could successfully alter the conventional wisdom. At least before the period of 2002 when the deflation became serious, the "good deflation" theory apparently dominated the debate among the media.

VI. Concluding Remarks

During the Showa depression, an economic policy of Japan shifted drastically from liquidationism through retuning to the gold standard at the prewar parity to a reflationary policy. Three quarters of a century later, the Koizumi Cabinet, which had advocated structural reform, shifted its policy stance by declaring that correcting deflation is one of its primary policy goals. In both cases, the obstacle for the change appeared to have been conventional wisdom, which was partly represented by the media. Foresighted economists' views on the issues were often in conflict with conventional wisdom of the time, and the power of sound views to influence those conventional norms was substantially blocked. Therefore, until the negative effects that followed unwise decisions became apparent, conventional wisdom did not wane or yield to reasonable policy shifts.

This phenomenon implies two important points in the relationship between the economics as a social science and the economics as a persuasion device. On one hand, from the logical positivism -- testing reality by refutation -- standpoint for economics as a normal science, the justification of a theory comes from empirical tests. If there are several theses or claims that exist around a certain economic issue, the thesis with the least number of flaws will be adopted as the contemporary knowledge. Needless to say, this process of testing theories by refutation process is quite important.

If a policy proposal is to go through the test by its actual implementation, the process of test or confirmation requires huge social and economic costs. This becomes especially apparent in a situation where conventional wisdom is extremely inflexible and enlightenment by economists has little influence on the society. Keynes and Fisher, two prominent scholars and enthusiastic

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[32] Eichengreen and Sachs (1985) have argued that recoveries of countries after the great depression were made possible by the mutual monetary expansions as a result of "competitive devaluation."

[33] Iwata (2001) and Noguchi (2002) are monographs that were written in part for enlightening purpose against the "good deflation" theory.

policy advocators, once tried to persuade and to enlighten the public in order to show the negative aspects of the gold standard. Even those giant economists, however, found that their recipes were not easily accepted by the public. As a result, policy measures were tested in real time and national economies incurred great economic loss.

The two serious examples in this paper indicate that the quality in economic understanding is crucially important to conduct a sound macroeconomic policy. Economic perception, often misleading perception, determines the macroeconomic policy making probably more than group interests surrounding political actors. Without proper education of the common economic knowledge accumulated in the profession for a long period of time, a society may conduct policy experiment that may cause a great deal of pains to the nation. It is important that economic education is done to reflect the current state of the economic profession, and it is an important question as well how advisers find proper ways of advising politicians and bureaucrats (Frankel, 2003).

Finally, the analysis of newspaper editorials clarified, and raised more questions, about the way the mass media interact with public opinions and influence actual policy making. Naturally, all the actors in politics, bureaucracy, business and voters have incentives to influence the mass media in turn. We are yet short of recording these interactions, and they will present us an interesting research agenda.

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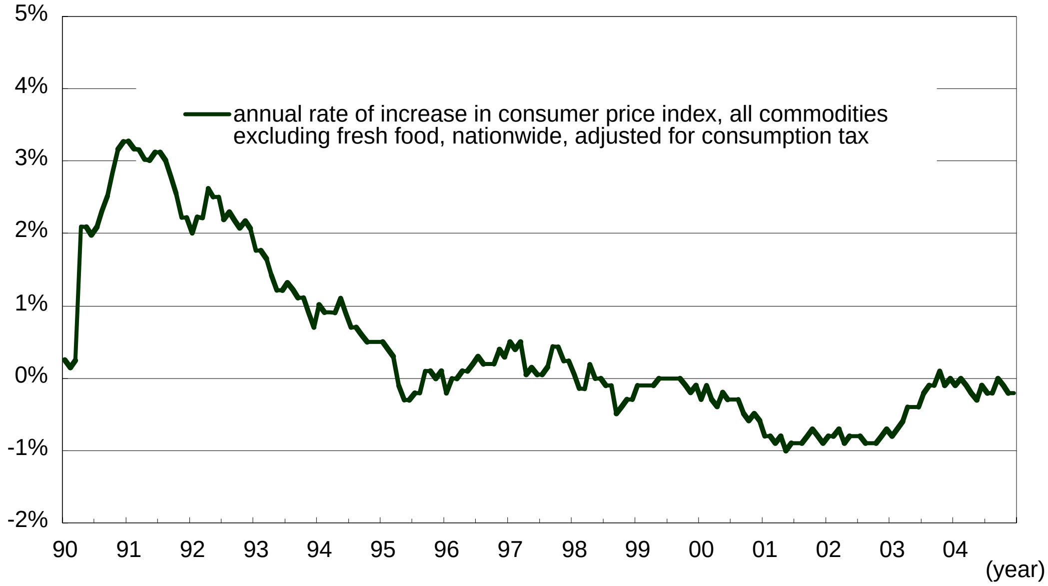
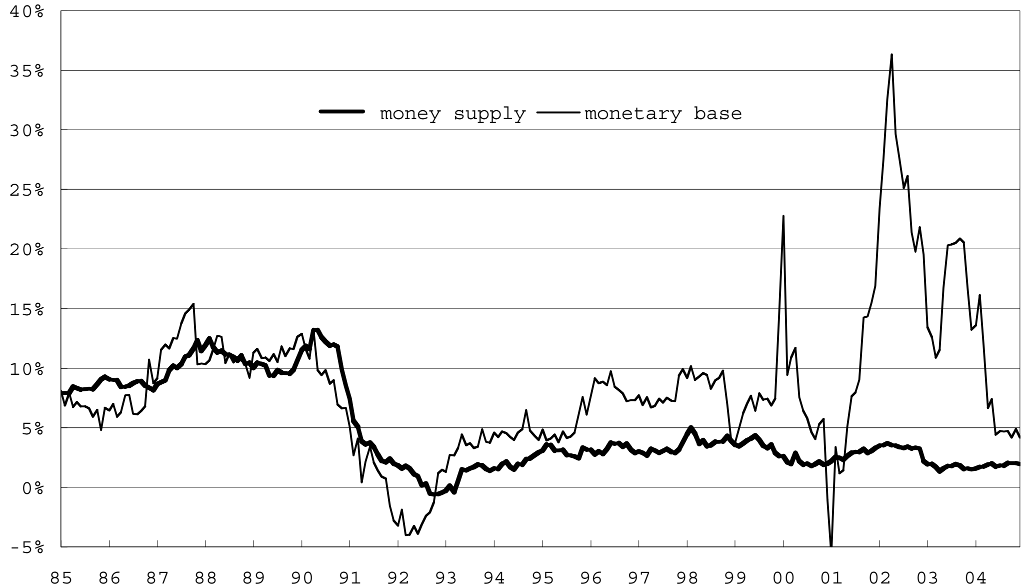
Figure 1. Rate of increase in Japan's consumer price index: 1990 - 2004



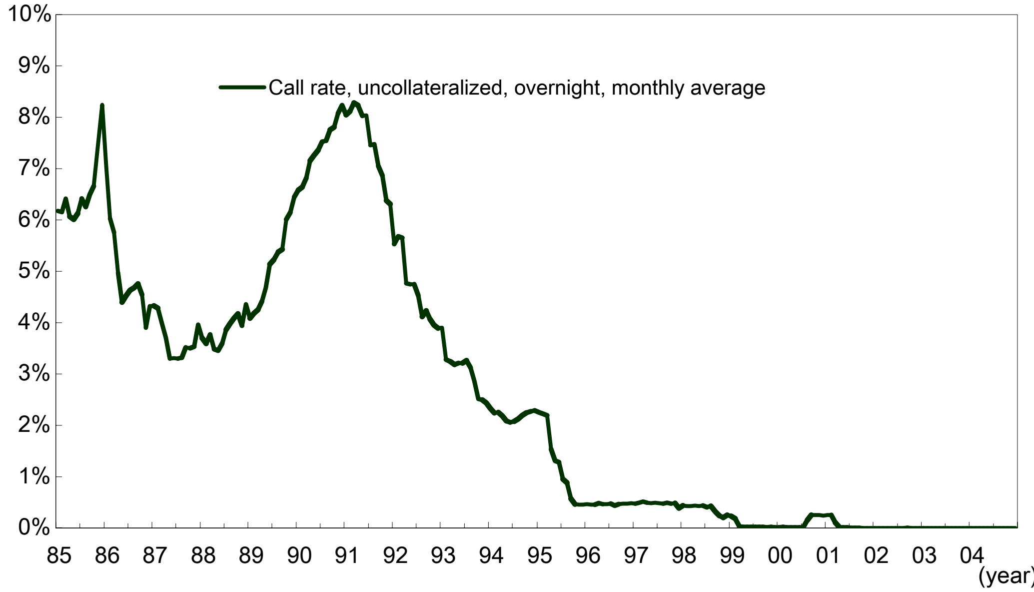
Source: Statistics Bureau of the Ministry of Internal Affairs and Communications

Figure 2. Annual rate of change in Japan's money supply and monetary base: 1985 - 2004



Source: Bank of Japan

Figure 3. change in Japan's short-term money market rate: 1985 - 2004



Source: Bank of Japan

Figure 4. Hits per year of the term "Defure (Deflation)" in the five biggest Japanese newspaper, Asahi, Mainichi, Yomiuri, Sankei, and Nikkei, by Nikkei Telecom 21 database

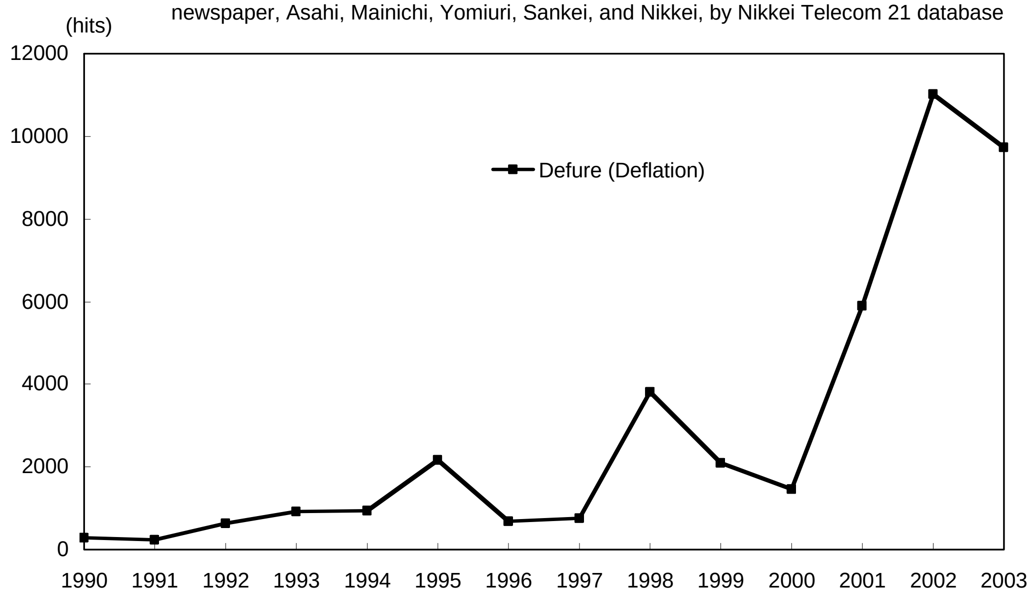


Figure 5. Hits per month of the term "Kozo Kaikaku (Structural Reform)" and "Defure Taisaku (Measures against Deflation)" in the five biggest Japanese newspaper, Asahi, Mainichi, Yomiuri, Sankei, and Nikkei, by Nikkei Telecom 21 database

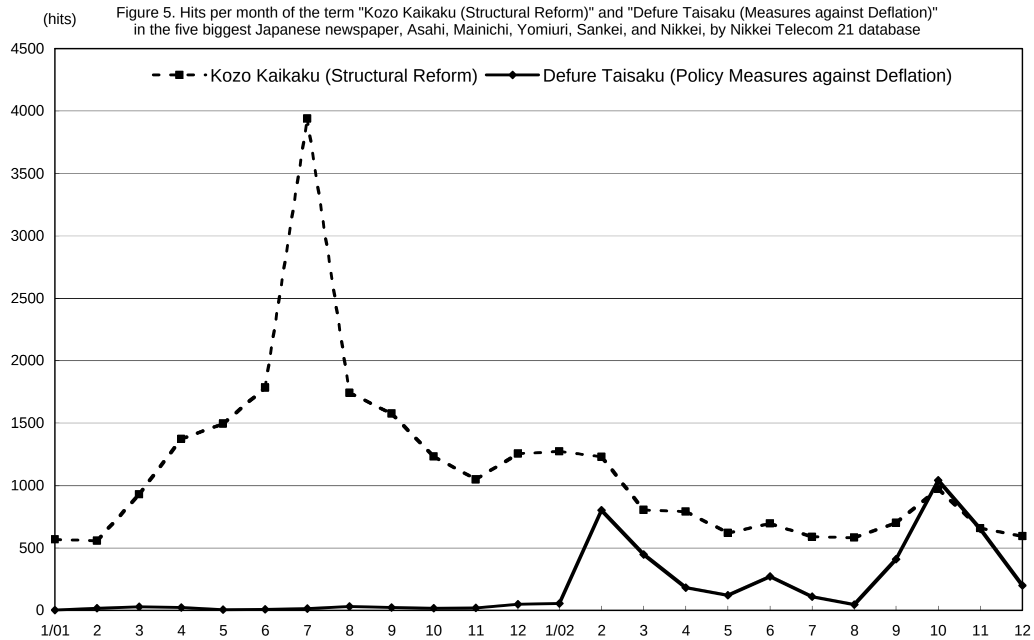


Table 1. The number of editorial articles from 2000 to 2003 that contain the word "Defure (Deflation)"

	Yomiuri	*Asahi*	*Mainichi*
2000	12	7	11
2001	90	7	20
2002	109	35	32
2003	90	34	39