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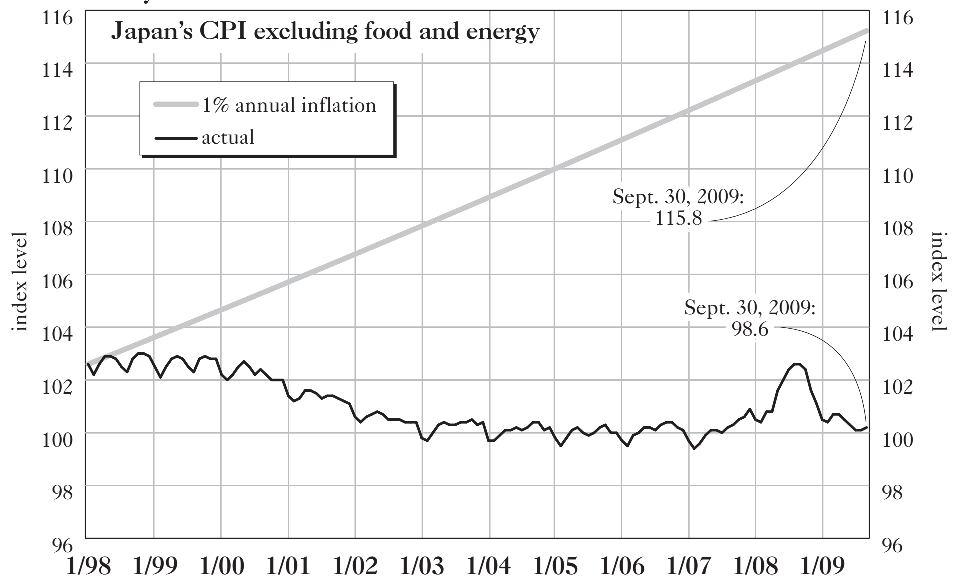
Bernanke at his word

It was no one slip of the Federal Reserve chairman's tongue that earned him his undignified nickname. Yes, the allusion by Ben S. Bernanke to a "helicopter drop" of money in an instantly famous speech in 2002 was the start of it. But that speech—"Deflation: Making Sure It Doesn't Happen Here," before the National Economists Club in Washington, D.C.—was only the chairman's most colorful public expression of his zero tolerance for price levels that don't lift. Undeterred by his critics' sniggering (or even their earnest disputations), then-Gov. Bernanke went further six months later in remarks to an audience of Japanese monetary economists.

The date was May 31, 2003, and a happy and confident time it was. The United States was well clear of the recession of March-November 2001. The bursting of the high-tech bubble had wrought no lasting damage on this economy or any other (or so it seemed). The Fed had cleaned up the mess with a succession of bold hacks at the funds rate. Mortgage rates, too, collapsed, and house prices powered fatefully higher. There seemed nothing that a hyper-interventionist central bank could not achieve. Possessing this remarkable skill, Bernanke graciously agreed to impart it to the Japanese.

The visiting American spoke frankly. "Deflation" was still eating away at the economy's innards, he reminded his hosts. And what was deflation? Falling prices, pure and simple. Bernanke did not bother to distinguish between prices that fall on account of a banking or credit crisis vs. those that fall on account of advances in productive technology or improvements in economic organization. It was all the same to him—and all bad. "[T]he opinions I give today," he said in preface, "are strictly my own and should not be attributed to my colleagues on the Board of Governors of the Federal Reserve or on the Federal Open Market Committee; nor do they reflect any official position of the United States government." Six years later, Bernanke's views can safely be attributed to the District of Columbia in toto. His view is writ.

That day in Tokyo, the Japanese heard a more radical Bernanke than domestic audiences have become accustomed to. It isn't enough, after prices have begun to fall, to stop the decline, the chairman said. Rather, a central bank should push prices up to where they would have been if they had never weakened in the first place. Under the 1998 law that established the Bank of Japan as a politically independent agency, "price stability" was the organization's principal remit. Yet, Bernanke pointed out, in the subsequent five years, Japanese prices had sunk by between 4% and 9%, depending on the index consulted. "One might argue that the legal objective of price stability should require not only a commitment to stabilize prices in

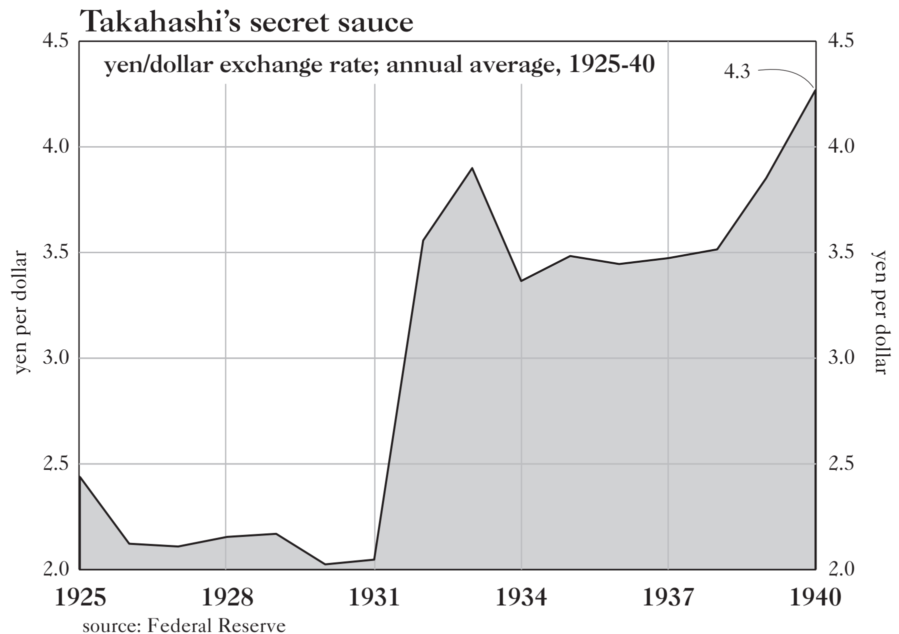


the future but also a policy of actively reflating the economy, in order to restore the price level that prevailed prior to the prolonged period of deflation," he said. One could so argue—and Bernanke did.

As his audience well knew, Bernanke was pushing for inflation targeting at home—let the central bank deliver that rate of currency debasement at which it takes aim, he often urged. Such a policy, he told the Japanese, would "anchor inflation expectations [and] reduce uncertainty in financial markets." Yet, he went on, "For Japan, given the recent history of costly deflation . . . an inflation target may not go far enough. A better strategy for Japanese monetary policy might be a publicly announced, gradually rising *price-level target*.

"What I have in mind," Bernanke continued, "is that the Bank of Japan would announce its intention to restore the price level (as measured by some standard index of prices, such as the consumer price index excluding fresh food) to the value *it would have reached* if, instead of the deflation of the past five years, a moderate inflation of, say, 1% per year had occurred. . . . Note that the proposed price-level target is a moving target, equal in the year 2003 to a value of approximately 5% above the actual price level in 1998 and rising 1% per year thereafter. Because deflation implies falling prices while the target price level rises, the failure to end deflation in a given year has the effect of increasing what I have called the price-level gap. The price-level gap is the difference between the actual price level and the price level that would have obtained if deflation had been avoided and the price stability objective achieved in the first place."

The price index to which Bernanke alluded had been falling by 1% a year since 2000. Even as he spoke, however, it was picking itself up and pushing higher. By 2004, it had rallied back to unchanged and proceeded to waver around the zero-percent-change marker for the next three years. When, in 2008, the oil market blasted off, so did the index, registering a gain in excess of 2% on the eve of the Lehman collapse. Then it was straight down til the 2.4% year-over-year decline posted in August. The latest reading, September's, was minus 2.3%.



Only imagine the benefits that a policy of "price-level-gap" targeting would heap on the Japanese economy, Bernanke beckoned his hosts. A proper reflation would lighten the burden of borrowers and creditors alike (done in as the creditors had been by weak asset prices and toppling banks). "A period of reflation would also likely provide a boost to profits and help to break the deflationary psychology among the public, which would be positive factors for asset prices as well. Reflation—that is, a period of inflation above the long-run preferred rate in order to restore the earlier price level—proved highly beneficial following the deflations of the 1930s in both Japan and the United States. Finance Minister Korekiyo Takahashi brilliantly rescued Japan from the Great Depression through reflationary policies in the early 1930s, while President Franklin D. Roosevelt's reflationary monetary and banking policies did the same for the United States in 1933 and subsequent years. In both cases, the turnaround was amazingly rapid. In the United States, for example, prices fell at a 10.3% rate in 1932 but rose 0.8% in 1933 and more briskly thereafter. Moreover, during the year that followed Roosevelt's inauguration in March 1933, the U.S. stock market rallied by 77%."

As Bernanke did not stop to point out, devaluation was the secret of the miracle workers of the early 1930s. Takahashi cut interest rates, cheapened the yen and ramped up government spending in what another scholarly admirer called "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." In the article of timing, Takahashi-san could almost not help but look good, for his immediate predecessor had restored Japan to the hard-money rigors of the gold standard three months after the 1929 stock market crash. That particular experiment ended in December 1931, after which it was off to the races. "After the yen's ties to gold were severed," wrote Dick K. Nanto and Shinji Takagi in a 1985 essay in *The American Economic Review*, "the exchange rate with the dollar depreciated by 50% in 1932 and another 50% in 1933 before recovering somewhat in 1934 [when the dollar was itself being devalued against gold, to $35 or so an ounce from $20.67 an ounce]. For the four years under Takahashi, the exchange value averaged 4.0 yen as compared with 2.2 yen per dollar for the four years prior to his becoming finance minister." Takahashi's grand design was to reverse these policies before they instigated inflation, but he failed to persuade the militarists that less was not less. They shot him dead in 1936. The economy was then humming, but the engine of growth was the coming Pacific war.

Bernanke, while eschewing any in-

delicate references to the 1930s, did address the obvious worry that there could be too much of a good thing. "Is there not some danger of inflation overshooting, so that a deflation problem is replaced with an inflation problem?" he posed and then answered: "No doubt, this concern has some basis, and ultimately one has to make a judgment. However, on the other side of the scale, I would put the following points: first, the benefits to the real economy of a more rapid restoration of the predeflation price level and, second, the fact that the publicly announced price-level targets would help the Bank of Japan manage public expectations and to draw the distinction between a one-time price-level correction and the BOJ's longer-run inflation objective. If this distinction can be made, the effect of the reflation program on inflation expectations and long-term nominal interest rates should be smaller than if all reflation is interpreted as a permanent increase in inflation."

However, it was no sale. Prices are falling in Japan today but the government and its central bank are seemingly unruffled by that fact. Whereas the Federal Reserve has more than doubled the size of its balance sheet since the onset of the fall 2008 crisis, the BOJ has shrunk its assets by 4.6%. Not only has the government of Yukio Hatoyama not intervened to halt the appreciation of the yen against the dollar, it has all but vowed not to intervene except in the event of disorderly trading conditions. It has pledged to cease the long-familiar Japanese practice of promoting growth through exports, a pet policy of Takahashi's. And to top it all off, the Bank of Japan, on Oct. 30, went on record with the forecast that the core CPI will fall by 1.5% in the current fiscal year and by 0.8% and 0.4% in fiscal 2010 and 2011, respectively. In the Bernanke worldview, the Bank has confessed its own impotence. Worse, perhaps, it has advertised its own lawlessness, insofar as the vaguely worded 1998 charter binds the Bank to policies delivering "stability."

As a monetary missionary to Japan, Bernanke has so far come up empty. But his Tokyo pep talk is a useful reminder of his own core beliefs. If there is going to be a voice in the Federal Reserve for a strong dollar, or for a monetary policy that draws an intelligent distinction between everyday low prices, on the one hand, and "deflation," on the other, it's going to have to be somebody else's. "Helicopter" is who he is.

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