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Comment Frederic S. Mishkin

Takatoshi Ito has written a very interesting and useful account of the Great Inflation of 1973 to 1974 in Japan and the role that the Bank of Japan played in generating it. The story he tells is that the Bank of Japan initially eased monetary policy too far in 1972 in the face of a stronger economy by lowering the official discount rate (ODR), its policy interest rate, and then did not tighten monetary policy sufficiently by raising the ODR in 1973 to contain rapidly rising inflation. The result was that in the aftermath of the oil-price shock that sharply raised energy prices toward the end of 1973, CPI inflation shot up to a peak of over 20 percent in 1974, well above what other advanced countries were experiencing.

In contrast, when the second oil-price shock struck in 1979, the rise in inflation was very moderate, staying below 10 percent, well below what countries like the United States experienced. In contrast to the 1973 to 1974 episode, the Bank of Japan did not pursue easy monetary policy before the second oil-price shock and started hiking the ODR before the oil-price shock hit in response to a strong economy. Then with the oil-price shock that again sharply raised energy prices in the fall of 1979, the Bank of Japan tightened monetary policy aggressively by raising the ODR, thereby ensuring that another Great Inflation did not occur.

Ito's chapter also explains why the Bank of Japan had such different policies in these two episodes that led to such different outcomes. He documents that the Bank of Japan eased monetary policy in 1972 because it underestimated the strength of the economy, but more importantly because it wanted to lower interest rates to prevent the yen from appreciating. The Bank of Japan was then slow to raise the ODR in 1973 because of political pressure from the Ministry of Finance and the prime minister. Then when it began to raise the ODR after the first oil-price shock occurred, it had gotten behind the curve and instead of real interest rising as inflation rose, it fell dramatically. The result was the Great Inflation of 1973 to 1974.

In contrast, the Bank of Japan seemed to learn a lesson from the Great Inflation episode and was able to tighten monetary policy even before the second oil-price shock hit, and then it raised interest rates aggressively once the second oil-price shock occurred because the Bank of Japan had obtained de facto independence and was now focused on achieving price stability.

Ito's account of Japanese monetary policy during the 1970s is important

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because it provides several key lessons about how monetary policy should be conducted to control inflation. Here I want to discuss four general lessons for monetary policy that I derive from his analysis: (a) oil-price shocks that sharply raise energy prices do not necessarily lead to great inflations; (b) an excessive focus on stabilizing the foreign exchange rate can have high costs; (c) a key source of the time-inconsistency problem is the political process, and so central bank independence is important; and (d) communication strategy is an important element of inflation control.

Oil-Price Shocks That Sharply Raise Energy Prices Do Not Necessarily Lead to Great Inflations

A common view that has been expressed about the Great Inflation in the United States is that the oil-price shocks of 1973 and 1979 played an important role in producing the very high inflation rates during this period. Ito's chapter shows that the importance of oil-price shocks in inflation outcomes is much less than this view might indicate. What the Japanese experience shows is that oil-price shocks that sharply raise energy prices do not lead to high inflation unless the monetary authorities are willing to tolerate high inflation and thus have little credibility as inflation fighters. Ito's account illustrates that the Bank of Japan (BOJ) was not focused on controlling inflation before the first oil-price shock hit. It had eased monetary policy earlier, despite a strengthening economy and rising inflation, and then was reluctant to tighten monetary policy when the oil-price shock hit.

Given this monetary policy stance, it is no surprise that monetary policy credibility to control inflation was very low when the oil-price shock struck. In such an environment, a sharp rise in energy prices would lead to a sharp rise in inflation expectations, which would add to the direct effects of the oil-price rise on inflation, thus causing inflation to sharply accelerate. Indeed, the fact that Japan's inflation rate rose more rapidly in response to the rise in energy prices than occurred in other advanced economies is well explained by the particularly low credibility of the BOJ.

Ito's evidence from his estimates of a Japanese Taylor rule drives this point home. Using a Taylor rule whose parameters were estimated over the low and stable inflation period from 1982 to 1995, he finds that the policy interest rate should have been far higher than it actually was during the Great Inflation episode, given the actual outcomes on inflation and the output gap. Indeed, he finds that the magnitude of the monetary policy mistake was huge: 20 percentage points. Although drawing conclusions from estimated Taylor rules has some tricky elements, the magnitude of estimates of the deviation from his estimated Taylor rule is so large that it clearly demonstrates Ito's point that monetary policy was far too easy during the Great Inflation period and must be seen as the reason why inflation went to such high levels.

In contrast, by 1979, the Bank of Japan, with support from the Japanese prime minister, made a much stronger commitment to achieving price stability. They displayed this both with rhetoric (which will be discussed later) and through actions. The BOJ tightened monetary policy before the second oil-price shock to contain inflation, and then when the oil-price shock occurred, raised interest rates aggressively. With stronger credibility as an inflation fighter, the response of expected inflation to the rise in energy prices was muted, and the result was that the rise in inflation was quite limited.

The conclusion from the Japanese inflation experience with these two oil-price shocks is an important one. Clearly, oil-price shocks that sharply raise energy prices do not necessarily lead to great inflations. If the monetary authority has credibility to keep inflation under control, then sharp rises in energy prices do not produce very high inflation. This illustrates why it is so important for central banks to have a clear-cut commitment to price stability: such a commitment, along with actions consistent with it, produces far better inflation outcomes. We saw this principle operating in the United States during the most recent oil-price shock that caused energy prices to surge in 2008. Despite the oil-price shock, core inflation rose very little, even when the Federal Reserve was lowering interest rates to cope with the contractionary shock resulting from the financial crisis that began during the summer of 2007. Not only does a commitment to and credibility for inflation control have the benefit of producing better inflation outcomes, but it also provides the monetary authorities with increased flexibility to use monetary policy to respond to negative aggregate demand shocks.

Excessive Focus on Stabilizing the Foreign Exchange Rate Is a Mistake

Ito's chapter points out that a major reason why monetary policy was too easy during the first oil-price shock episode was because the Japanese government and the BOJ did not want to allow the yen to appreciate further. The result was a surge in inflation. The focus on the exchange rate therefore led to an undesirable inflation outcome.

An excessive focus on the exchange rate can also cause monetary policy to be too tight when the economy is hit by a contractionary shock. One striking example occurred in Chile in 1998, when the Chilean central bank was reluctant to ease monetary policy and let the exchange rate depreciate in order to cushion the effects of substantial negative terms of trade shock (Mishkin and Savastano 2000). Instead, the central bank raised interest rates and even narrowed the exchange rate band. The excessive focus on the stabilizing the exchange rate thus lead to contractionary monetary policy when it needed expansionary to offset the contractionary effects of the negative terms of trade shock. The result was that inflation fell below the Banco Central de Chile's inflation objective and the economy went into a recession.

The lesson from the Japanese, as well as the Chilean, experience indicates that an excessive focus on the exchange rate can lead to poor monetary policy outcomes. Excessive focus on stabilizing exchange rates can lead to serious monetary policy mistakes.

A Key Source of the Time-Inconsistency Problems Is the Political Process, so Central Bank Independence Is Important

The classic model of time-inconsistency in monetary policy, Barro and Gordon (1983), has central banks deviating from the optimal plan and pursuing inflationary monetary policy because the central bank is aiming for an unemployment target below the natural rate. Because central banks can avoid falling into the time-inconsistency trap by just recognizing that it exists, doubts have been whether the time-inconsistency is an important problem for monetary policy.

The story that Ito tells about the Great Inflation period in Japan indicates that political pressure on the BOJ was an important reason why it decided to ease monetary policy in 1972 before the first oil-price shock and then did not tighten monetary policy when it was needed in 1973. As discussed in the chapter, Prime Minister Sato met with Governor Sasaki of the BOJ in May of 1972 and pressured him to lower the policy rate to prevent an appreciation of the yen. Then, when Prime Minister Tanaka came into power with a goal of pursuing large public work projects, he was opposed to interest rate hikes. In addition, the BOJ felt that it could not raise interest rates during the budget process and so delayed raising the policy rate until April of 1973. Ito tells us that the Bank of Japan was unable to resist political pressure to keep interest rates low.

The Japanese experience provides support for the view that it is the political process that leads to the time-inconsistency problem and overly expansionary monetary policy. Hence, there is still a strong case for the time-inconsistency problem to be an important source of overly expansionary monetary policy that leads to high inflation. This evidence provides support for a position that I have argued elsewhere (Mishkin 2000): the source of the time-inconsistency problem is likely to be in the poltical process and not inside the central bank itself.

Ito argues that the reason why political pressure was so effective during the Great Inflation period was that the BOJ had very little independence at the time. The governor of the BOJ could be replaced at the will of the government and there was a tradition that any change in monetary policy had to be negotiated with the Ministry of Finance and the prime minister. The Great Inflation episode thus provides a strong case for central bank independence to alleviate the time-inconsistency problem.

Ito does make the claim that the better performance of the BOJ during the second oil-price shock was due to the Bank of Japan having been given de facto independence. I am somewhat skeptical that this is the best way to describe what in fact had occurred. There was no change in the Bank of Japan Act and it was not until 1998 that a new Bank of Japan Act granted the BOJ substantially more independence. What enabled the BOJ to pursue tighter monetary policy was the support that Prime Minister Ohira gave to the BOJ to pursue this policy. In one sense we could think of this support as increasing the BOJ's independence to pursue the monetary policy that it thought was necessary, but the ability of the BOJ to conduct this policy was still dependent on personalities. A different prime minister might not have been as supportive of the BOJ, and in that case the BOJ's "independence" would have evaporated.

Communication Strategy Is an Important Element of Inflation Control

The chapter also discusses the BOJ's use of monetarist rhetoric to provide a better theoretical underpinning for inflation control after the Great Inflation episode in 1978. Specifically, the BOJ had turned to announcing a "forecast" of the growth rate of the money supply (M2 + CDs). It is not clear how important this monetarist rhetoric was in helping the BOJ to resist political pressure and thereby enhance its ability to pursue an independent monetary policy to control inflation. Furthermore, as Ito points out, the BOJ did not engage in a monetarist *k* percent rule along monetarist lines. However, the increased focus of the BOJ on rhetoric to emphasize the importance of controlling inflation might have helped its case with politicians to focus on inflation control. What is clear is that the government was much more supportive of BOJ monetary policy tightening to control inflation in the 1979 to 1980 period. There is a good case to be made that the BOJ's communication strategy helped it to pursue anti-inflationary monetary policy with much success during this period. The Japanese experience in that period was supportive of an important principle of monetary policymaking, which is that communication strategy is an important element of inflation control.

Conclusion

Takatoshi Ito's chapter on the Japanese monetary policy and the Great Inflation is well worth reading. It provides an important service because it teaches us valuable lessons that are applicable to how monetary policy should be conducted, not only in Japan, but also everywhere else.

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