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Market Comment

CLARMOND

Resurrecting Reflation.

We are constantly reminded to learn lessons from Japan's lost last two decades. Perhaps an earlier period in Japanese history provides equally important instructions for our current conundrum. The results of massive Quantitative Easing are not always what you expect.

ON MAY 31 2003 GOVERNOR BEN S. Bernanke addressed the Japan Society of Monetary Economics in Tokyo. In his speech he admonished the Bank of Japan (BOJ) for the policy lapses that had been made since the 1990s and offered the following remedy:

"A period of reflation would provide a boost to profits and help break the deflationary psychology, which would be a positive factor for asset prices. 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."

So who is this enigmatic and 'brilliant' Takahashi Korekiyo that a historical minded Fed Governor was conjuring up?

The Japanese pre-Keynes

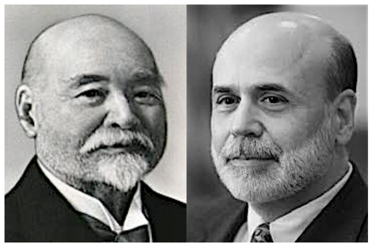
Takahashi Korekiyo was one of the great politicians of pre-war Japan. Spanning three decades he served as Governor of the Bank of Japan, Finance Minister and Prime Minister; his last post was again as Finance Minister between 1931-36. Starting in 1931 Takahashi enacted policies that prepared the way for Japan's reflation. Keynes would have been proud.

- He took Japan off the gold standard allowing the Yen to float freely;
- He outlawed conversion of paper currency to gold;
- Slashed interest rates;
- Enshrined the ability of the BOJ to buy and warehouse government bonds for sale in the future; and
- Finally he enacted massive government deficit spending.

In modern financial jargon he combined Quantitative Easing with deficit spending, a true marriage between the Federal Reserve and the Federal Government. No wonder Governor Ben Bernanke praised Takahashi so highly.

Initial Success

Takahashi's policies were immensely successful. The equity markets tripled, the Yen fell by 40% and exports boomed, at a time when global trade was contracting. People were re-employed, incomes rose, and inflation remained low; Japan had a growth rate of nearly 6% for 5 years, a true nirvana. But the rotten underbelly of this triumph was that most of the deficit spending was funding warfare, the military received all the money it demanded. Takahashi knew he would have to cut spending aggressively when in late 1935 the BOJ's attempt to sell its warehoused government bonds resulted in a failed auction. The



Mirror,mirror...

addiction to deficit spending had to end. The military was informed; they did not take it well, and a group of young officers hacked to death the 82 year old Finance Minister. The new Finance Minister promptly continued the deficit spending programme. The rest is history.

The Japanese Lesson

Replace warfare with welfare and we bring Takahashi's tale into the modern era. Welfare in this instance can take many guises, from the financial sector to the public sector. QE and deficit spending starts with the best of intentions, but such easy money leaves the door open to unknown actors. In Japan's case it led to militarisation and war; we await to see who sits at our table today.

Perhaps the polite Japanese audience in 2003 were recalling the much more turbulent and violent outcome of their last sustained programme of QE and deficit spending. Chairman Bernanke may wish he never invoked the spectre of Takahashi Korekiyo. ■