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

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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 has prolonged the stagnation of the Japanese economy since the 1990s. While the current framework of political economy is based on the self-interest 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, as dominant forces influencing economic policy making.

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1. Introduction

This paper examines the role of misleading economic ideas played in the economic disasters of two deflationary periods in Japanese economic history. Most likely, erroneous thinking deepened the depression during the interwar years, and misleading economic understanding has 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-interest 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 macroeconomics where the impact of a particular policy is rarely clear to the public. We present two significant examples in which erroneous thinking rather than conflicts of interest apparently misled policy decision-making in Japan's macroeconomic history. Thus we seek to reexamine the role of preconceived perceptions in contrast to economic interests as factors influencing policy making.

This paper is motivated by the prolonged recession in Japan that has endured since the 1990s and has been aggravated by continuing deflation during the past several years. Economic principles tell 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

[1] Becker (1983) and Stigler (1971), among the influential authors on this subject, emphasized the framework in which 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 stressing the role of bureaucrats, that politicians (principals) are more influential than their agents.

combined with recession since the 1990s was the too abrupt, miscalculated monetary contraction aimed at halting the asset price boom, or bubble, in the late 1980s. As the Federal Reserve Board (FED) economists, Ahearne et. al., (2002) note, 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, because conventional monetary policy did not show positive results immediately, new instruments of monetary policy needed to be examined and tested.[2]

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 originating 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 to achieve rationalization, that is, Schumpeterian creative destruction."[3]

In microeconomic matters, most policies have well-understood impacts on the constituencies most directly concerned. But on macroeconomic issues, on the other hand, the incidence of economic policy is usually 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

[2] Needless to say, we never discount the merits of microeconomic structural reforms including deregulation and the clearing of the outstanding, enormous, nonperforming debt for correcting the situation. The delinquent debt problem came, of course, partly from a 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.

during the inter-war years of the 1920s to 1930s.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 a view that contradicts the mainstream understanding in economics.

During the inter-war years of the 1920s to 1930s Japan experienced an economic policy failure that had extremely serious welfare consequences. Policy makers as well as a majority of economists misunderstood the consequences of a macroeconomic policy focused 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 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 has exacerbated the deflation and recession since the 1990s. This paper aims accordingly 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 2, as a positive theory of political economy, we contrast the two views concerning what motivates 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 on the importance of conceptual or epistemological aspects of the 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 in which the impact of policy actions is far from obvious and, therefore professional knowledge needs to be seriously considered.

In Section 3, 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 4 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 5, 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 illustrate how they were arguing wrongly about the origins of deflation as well as the policy that should be in place in its presence.

In the concluding section, we offer two questions for further research: (1) Given that some ideas were in error and misleading for macroeconomic policy, were these ideas generated independently, or as the result of manipulation by pressure groups? (2) 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)

2. 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 the mainstream economic tradition agree that deflation as well as inflation is a monetary phenomenon and monetary policy is the most effective policy assignment. Often, these basic principles are not necessarily understood by the general public. And they 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 Kaldor (1939) argued, 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 well-being 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.

3. 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 his last chapter in *The General Theory of Employment, Interest and Money* (1936) highlights the power of ideas in spite of short-term or medium term interests.[4] Stigler (1971), on the other hand, stresses the 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.

[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 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)

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 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 theory of rational choice is considered the appropriate approach to emphasize the role of conflicting interests. 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) have 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 rational choice theory. Rational choice is conducted for optimizing or satisfying (à la Herbert Simon) behavior under constraints that include what is believed to be the mechanism of the world. 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 differ from agent to agent depending on the group classification and the idiosyncratic nature of an agent. Though each rational agent may be

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

motivated by his economic motive given the perception of the world, an agent's decision can differ depending upon what kind of view he has concerning the mechanism of the economic universe.[6]

Blyth (2002) 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 hypotheses seem reasonable and should be subject to empirical testing. In addition, one should not neglect the existence of ideas that create disorders and even revolutions. As Blyth states (p. 32) convincingly: "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 uncertainty."

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 for 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 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.

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

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

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 the context of international relations, Haas (1992) juxtaposes the approach that emphasizes ideas with 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 newcomers 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 agents 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 a different implication from what the conventional 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, as in 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 own selfish ground. If perception of the economic universe is different among agents, and often erroneous, however, the aggregate outcome can depart from the desirable outcome. Our hypothesis is as follows. 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 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

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

matter is highly technical, as in the case of the return to the gold standard or a 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, the individual actors in a nation.[10]

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

4.1. 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 was the main issue on the 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 two groups. 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 the disruption of the war and restoring the 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

[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.

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 value of the currency relative to gold. Some of them went so far as to contend that the gold standard system itself should be modified or replaced by a more rational currency system. Fisher (1913; 1920) advocated the "compensated dollar" plan intended to stabilize the dollar price of a 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, 1971) argued for a managed currency system without gold, an idea which 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 abandon the gold conversion of their currencies which 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 experienced severe inflation immediately after the war. Generally speaking, moderate monetary tightening by central banks is the most efficient way for suppressing inflation. In 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 render it sufficient to restore the price level in place at 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 would provide a transitional and temporary process of monetary adjustment, and the economic distress would be eventually remedied as prices continued to be reduced. Nevertheless, the necessity for such a policy of monetary contraction and deflation was

[11] Their writings closely associated with the topic are Cassel (1921), Fisher (1922), and Keynes (1977).
[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 of the "rules of the game on the international gold standard system," see McKinnon (1993).

extremely dubious. The economists argued, in view of the substantial cost of deflation during the adjustment 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 in terms of the time inconsistency of a government policy. In this context, adhering to a predetermined gold parity was 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 remarked: "the idea of a deflation, bringing back the value of that money to its prewar 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. More generally, however, the economists who 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 economists' views, though foresighted, were hardly accepted outside academia. They were considered by the general public to reflect academic eccentricity and were never taken seriously by policy makers. This was 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 in 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]

[13] As noted in Keynes (1971, p. 118n), the general proposals of the Genoa Conference in 1922, to which Keynes made some contributions, appropriately affirmed the option of devaluation by a member country, and Keynes was critical of the officials of member countries attending the Conference. Cassel, another prominent participant at the Genoa Conference, made a similar suggestion, as noted in 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, implemented Britain's return to the gold standard at the prewar parity with overwhelming public support. Immediately after this, Keynes published his famous pamphlet, *The Economic Consequences of Mr. Churchill* (1925, 1981), in which he accurately predicted the economic difficulties that occurred in Britain, namely, deflation, unemployment, and social turmoil. This is probably one of the reasons

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.

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, developed by Temin (1989), Eichengreen (1992), Bernanke (2000b), and others.[15] The international view establishes that the gold standard rebuilt after the WWI was directly responsible for the world economic crisis that followed. Under the gold standard system, every country had to tighten domestic credit when gold reserves were reduced, 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 inflow of gold. Thus, the international gold standard system has an endogenous tendency for mutual monetary contractions. The worldwide diffusion of depression in the 1930s was 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 its freedom for monetary expansion that the country could find a way to escape from the depression.

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why Keynes compared himself to Cassandra, ignored prophetess in Greek mythology, in his preface in *Essays in Persuasion* (1931, 1972).

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

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.

4.2. The Controversy Around the Restoration of the Gold Standard and Its Consequence

Japan emerged 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 involved in a major way in WWI, it followed other countries by suspending the gold conversion of its national currency in 1917. As soon as the war ended, 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 journalists. The repeal of the gold embargo at that time was synonymous with a return to the gold standard. The controversy about the repeal of the gold embargo, one of the most heated controversies throughout Japan’s history, echoed controversies in other countries. On the 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 academic circles 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 favoring the devalued gold parity restoration were not academic scholars, but their economic knowledge and their capability to understand current levels of economics apparently greatly surpassed their opponents who were mostly in universities. They were far more familiar with the contents and 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 developed a theoretical basis for their opposition to Japan's prewar gold 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 later published in a series of special supplements in *The Manchester Guardian Commercial*. At the Conference, Keynes worked for the Financial Commission with 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

[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, "The repeal of the gold embargo" 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 favoring the devalued gold-parity restoration included Senjiro Takagi of Keio University, who had studied economics and obtained a doctorate under the mentoring of Irving Fisher.

Commercial. This series contained Keynes' own articles that were to become the core of his *Tract on Monetary Reform* (1923), as well as the other significant writings by 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," taken from *The Manchester Guardian Commercial*, 20 April 1922. It was Kamekichi Takahashi, then an in-house writer for the *Oriental Economist*, who wrote a summary of Keynes' idea. This brief article by Takahashi was 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 of their practical influence on policies. Above all, the opponents remained in the minority. Among the economic media, the *Oriental Economist* 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 in 1930. Junnosuke Inoue, then the Finance Minister in the Osachi Hamaguchi cabinet, initiated this policy. Since 1929, the Hamaguchi Cabinet had considered the return 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, and the motto "repeal of the gold embargo" became 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, is evident in his booklets entitled *The Restoration of National Economy and the Repeal of Gold Embargo* (1929a) and *The Repeal of Gold Embargo: An Appeal to all of the Nation* (1929b). These books contained many popular rhetorical expressions of the time in support of repealing the gold embargo at the prewar parity even though the adjustment might be painful to the economy.

Japan thus 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 was exactly the state of affairs that had been accurately anticipated by foresighted economists, i.e., an unprecedented economic crisis associated with severe 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 Britain's abandonment, Japan became a target for selling 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 assassination of many of major actors including Korekiyo Takahashi, Junnosuke 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 the Zaibatsu, represented by Takuma Dan (who was also assassinated) and Seihin Ikeda, might have found the stability and low-pressure economy, that they imagined would result, congenial for their material interests. We cannot imagine, however, that the return to gold standard was solely triggered

[17] A famous anecdote illustrates how the common people at that time were excited by the policy espoused by Hamaguchi and Inoue. In 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.

by their business interests.

4.3. 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 drawn from conventional thought.

What was actually the substance of the preconceived ideas espoused by conventional thought? It is possible to 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 Junnosuke 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, public opinion should be given more attention. Since there are no direct sources of public opinion or the preconceived idea possessed by the public, what we have done is to consider newspaper editorials as a documented proxy for public opinion.

There are several reasons for assuming that opinions appearing in newspapers should be a good reflection of preconceived ideas held by the general public. A majority of readers of the major general newspapers are not the 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 disseminating information on policy subjects of national interest to various levels of the population. 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 therefore 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, newspapers may attempt to change the general opinions of the public. If the latter channel is workable at all, then politicians, administrators, business groups and non-governmental organizations (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, has 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 the controversy was most heated. During this period, the 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 supported by Korekiyo Takahasi, then the Finance Minister of the Tsuyoshi Inukai Cabinet. We owe a great debt to Muneyoshi Nakamura for the editorials that we have used to document our analysis.

Based on Nakamura's compilations of editorials, we have compiled a number of citations that are pertinent to the public perceptions of the issues relating to the policies and effects that occurred. Because of space constraints, we cannot include these citations here, but they are contained in a longer version of this paper available from the authors on request.

The conclusions from our survey of the editorials can be summarized as follows. There were apparently two preconceived ideas or myths concerning the repeal of the gold embargo. The first myth was the notion that the legitimacy of a currency could not be guaranteed unless the country is on 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 which 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 called "liquidationism" or the idea of creative destruction.[18] 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 the studied wisdom of experts. The result had serious consequences especially when the two ideas were contradictory. As 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 resulted in 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.

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

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

[18] 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 (1938, p. 145) said that it was the "equivalent of crying, 'Fire! Fire!' during Noah's flood."

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

5.1. The Long Stagnating Japanese Economy under Deflation

Japan's economy has been going through an unprecedented long period of deflation since the late 1990s. After the burst of the "bubble" economy in the early 1990s, asset prices started to decline rapidly. Partly due to the appreciation of the yen, the consumer price index (CPI) declined to a negative range in 1995. Although the inflation rate recovered slightly from 1996 to 1997, partly due to the increase caused by a rise in 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). The decline in the CPI 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-rate 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.

In the course of the 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 and eventually dropped to a negative range in 1998. At the same time, the jobless rate steadfastly increased considerably beginning in the early 1990s, rising from 2 percent in 1990 to 5.4 percent in 2003. Japan's deepening deflation was thus accompanied by a weakening of the real economy. "Japan's lost decade" depicts the situation quite accurately.

Looking for the causes for this long stagnation has led to serious debate among numerous scholars and economists.[19] We hardly have room here to delve into the details of the debate. It is clear, however, that the diminishing GDP growth rate and increasing jobless rate were strongly tied

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

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 considerably during the bubble period of the late 1980s to the early 1990s (Figure 2). The increases in those two monetary 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 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 in order 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.[20] As can be seen in Figure 2, the tightening monetary policy after 1990 was causing a sharp decline in the money supply and monetary base. 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 has 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 the 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 opinion 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 positions. 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.[21] The reluctance of the BOJ towards

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

[21] Ahearne et al. (2002, p. 13) say that "The 1993-94 period may have been particularly crucial for monetary

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 sector after the burst of the asset-price bubbles (Truman, 2003, p.145).

The fact that the policy rate was approaching an extremely low level implied that the BOJ had lost its conventional means of implementing 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 inflation rate slipped to below zero. Japan's economy was thus 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 the 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 over 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-rate policy that the BOJ considered "abnormal." They were eagerly awaiting the departure from this "unusual" zero-interest-rate policy situation. In 2000, however, the BOJ leaders decided to raise the call rate in order to depart from the zero-interest-rate policy, although deflation was still

policy, since that is the last time (with the exception of the short-lived response to the VAT increase 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."

pervasive. 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.

5.2. 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 experienced the Great Depression. Krugman (1998), Bernanke (2000a), and Svensson (2001) were among those influential 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 in the 1920s.

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-rate policy. Some economists agreed with the arguments made by economists abroad. They advocated introduction of non-traditional monetary policy devices such as an 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 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, which is that deflation is harmful to the economy and had to be overcome. It should be noted that this basic agreement on the harm of deflation only existed among experts and 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 around 2002, when deflation became more severe, popular discussions in journalistic circles tended to identify “good deflation” and praise it. They explained the extent to which a deflationary economy benefits consumers through economizing on 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 competition within a global economy. Naturally, in such an atmosphere, a majority of economists who advocated expansive monetary policy to break away from the deflationary economy were seen as promoting unhealthy inflationary policies. Those enemies of deflation were criticized and even mocked 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 that deflation had much to do with the stagnating economy. Unfortunately, people had to go through the pain of deflation in order to break the spell of “good deflation.”

We now turn to the role of mass media in this period. Deflation had hardly drawn sigificant 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 the deflationary economy became really serious.

The same tendency can be found for the frequency in the media’s attention to 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 led in April of 2001 to Junichiro Koizumi becoming 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.[22]

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

[22] 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.

for the shift in government's policy stance. In the next section, we will elaborate on this point by summarizing the opinions of newspaper editorials during this most critical period of the Japanese economy, from the year 2000 to 2003.

5.3. The Trend in Editorial Opinions in Major Newspapers on the Issue of Deflation

We have surveyed the trend of editorial opinions in three Japanese newspapers, the *Asahi*, *Mainichi* and *Yomiuri*. The circulations 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. The 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.[23]

Table 1 shows the result of counting the number of editorial articles from 2000 to 2003 that contain the keyword "Defure (Deflation)." The *Yomiuri* mentioned the word far more times than the other two. The persistence of the *Yomiuri* in mentioning deflation was quite distinct.[24] *Mainichi's* "pro-deflation" editorials expressed the opposite side of those in the *Yomiuri*. In fact, both sides criticized the BOJ's policy implementation under Governor Hayami severely, although from the mutually opposite directions.

Among three major newspapers, the *Asahi* represented the average view of the media. The basic 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 the deflationary economy at the beginning of 2003. Still, it kept opposing the adoption of a quantitative easing policy or an inflation target. At 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 in accord with the policy shift of the emphasis of the government from "Structural Reform" to "Against Deflation."

[23] These figures are from the "Newspaper Publishers Report" published by Japan Audit Bureau of Circulations (JABC).
[24] 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.

In a longer version of this paper we have also examined the content of the editorial articles of the three major newspapers, divided into several sub-periods from 2000 to 2003. The details are not reproduced here but are available from the authors on request.

5.4. Meaning of Conventional Wisdom on Deflation

As already stated, the Japanese government placed its priority on "conquering deflation" as high as structural reform on its policy agenda. In such a political environment, the government appointed three new members to the executive office of the BOJ headed by Governor Toshihiko Fukui.[25] Because of the BOJ's reluctance to ease monetary policy 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 the strong impression to the outside world that the BOJ shared the same goal with the government in implementing aggressive monetary easing measure by itself.[26] Helped as well by the recovery of the world economy, the seriousness of Japan's deflation started gradually declining.

Although there were differences in 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 periods, the deterioration of the economic environment forced the government to shift its policy. That is, the implementation of necessary policy measures was constantly postponed and prevented until there was a crisis or near crisis because of preconceived ideas. For example, the newspapers, based upon the "good deflation" theory, often encouraged the BOJ to lift its zero-interest-rate policy and criticized the government's effort to persuade the BOJ to ease money. This was the case even though there is little or no basis to support the idea of "good deflation" in modern macroeconomics.

[25] The 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 at Tokyo University.

[26] When the government selected Fukui as a new governor of the BOJ, he was not welcomed by the foreign media. Fukui was perceived by many as a successor of Hayami, a former governor of the BOJ who was extremely careful and even reluctant to adopt monetary policy management during his governorship. However, once Fukui adjusted BOJ monetary policy on the right course, the foreign media praised him highly.

6. Concluding Remarks

During the Showa depression, economic policy in Japan shifted drastically from "liquidationism" brought on by returning to the gold standard at the prewar parity to an anti-deflationary 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 to 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 the 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 economics as a social science and 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 pertaining to an 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 policy advocators, once tried to persuade and 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 historical examples in this paper indicate that the quality of economic understanding is crucially important in conducting a sound macroeconomic policy. Economic perception, often misleading perception, determines macroeconomic policy making probably more than group interests involving political actors. Without the appropriate education derived from the common economic knowledge accumulated in the profession for a long period of time, a society may conduct policy experiments that may cause a great deal of pain to the nation. It is important that economic education reflects 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, our analysis of newspaper editorials clarified and raised many questions, about the way the mass media interact with public opinion 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 their pursuit represents an interesting agenda for further research.

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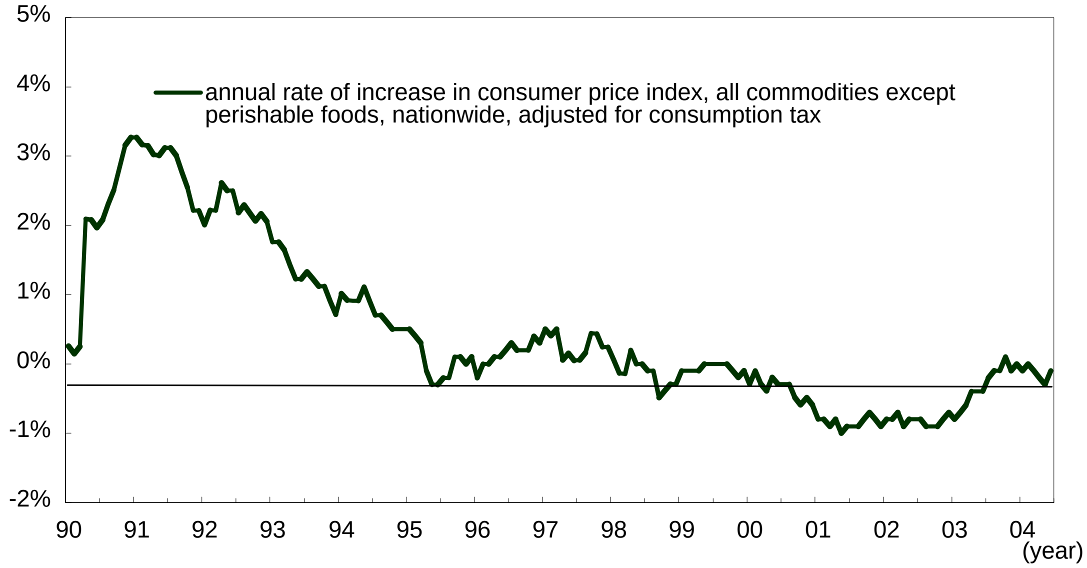
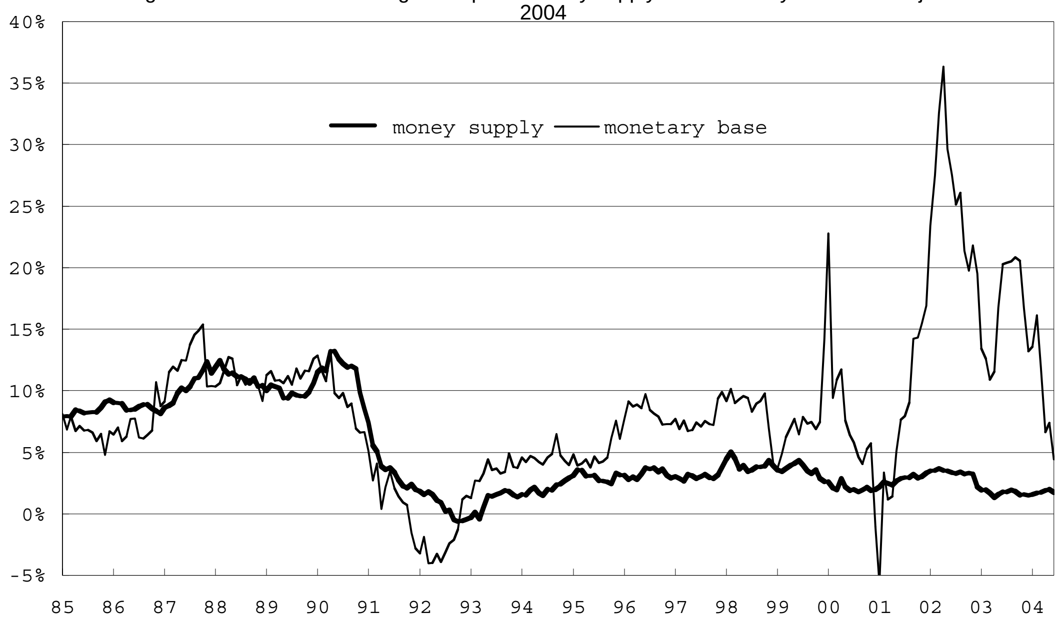
Figure 1. Rate of increase in Japan's consumer price index: 1990 - june 2004



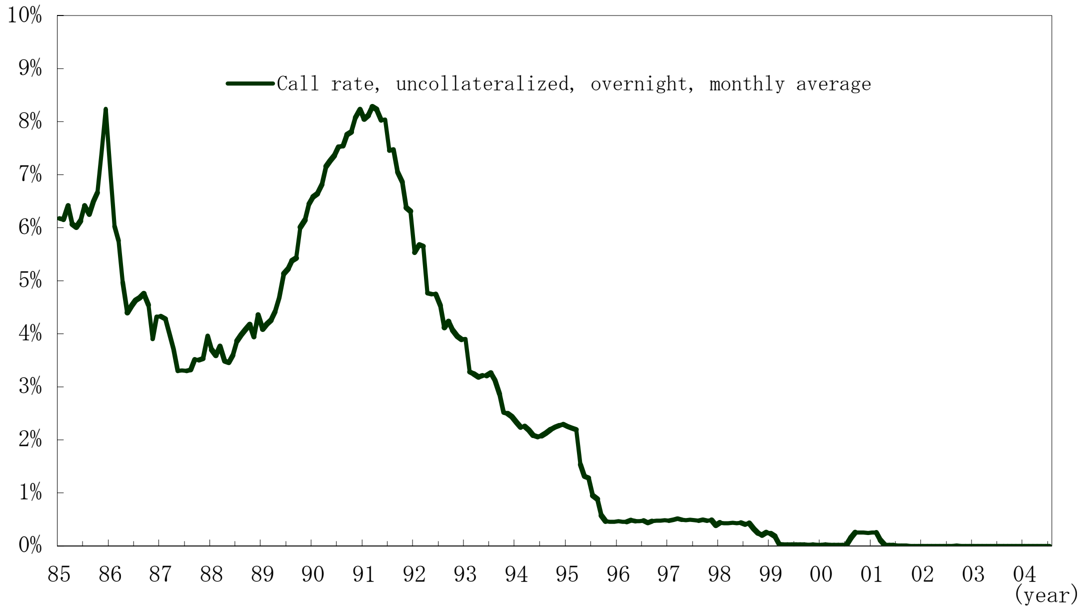
Source: Statistics Bureau of the Ministry of Internal Affairs and Communications

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



Source: Bank of Japan

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

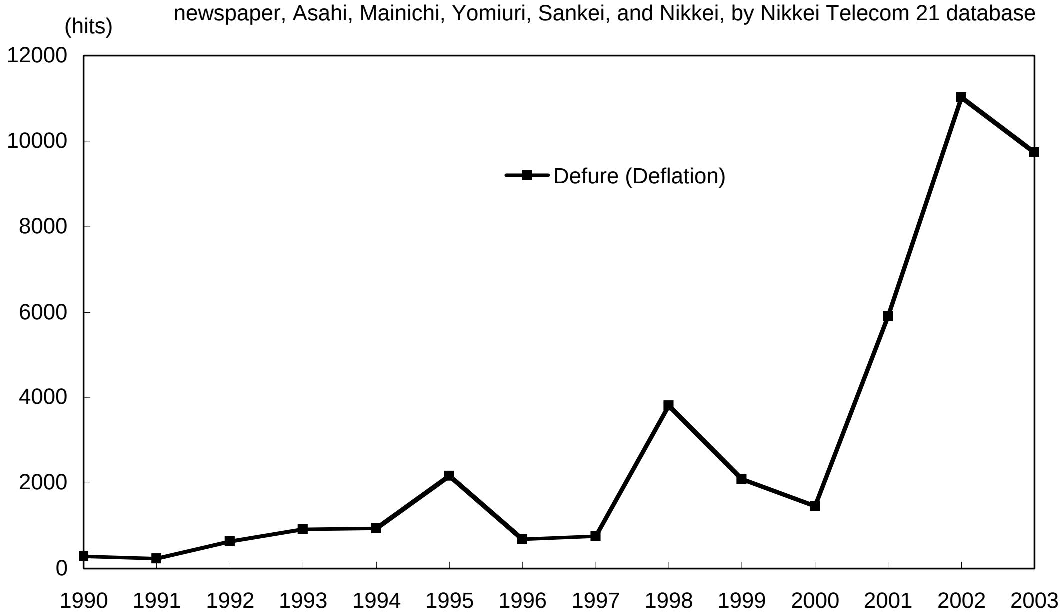


Figure 5. Hits per month of the term "Kozo Kaikaku (Structural Reform)" and "Defure Taisaku (Measures against Deflation)" in the five biggest Japanese newspaper, Asahi, Mainichi, Yomiuri, Sankei, and Nikkei, by Nikkei Telecom 21 database

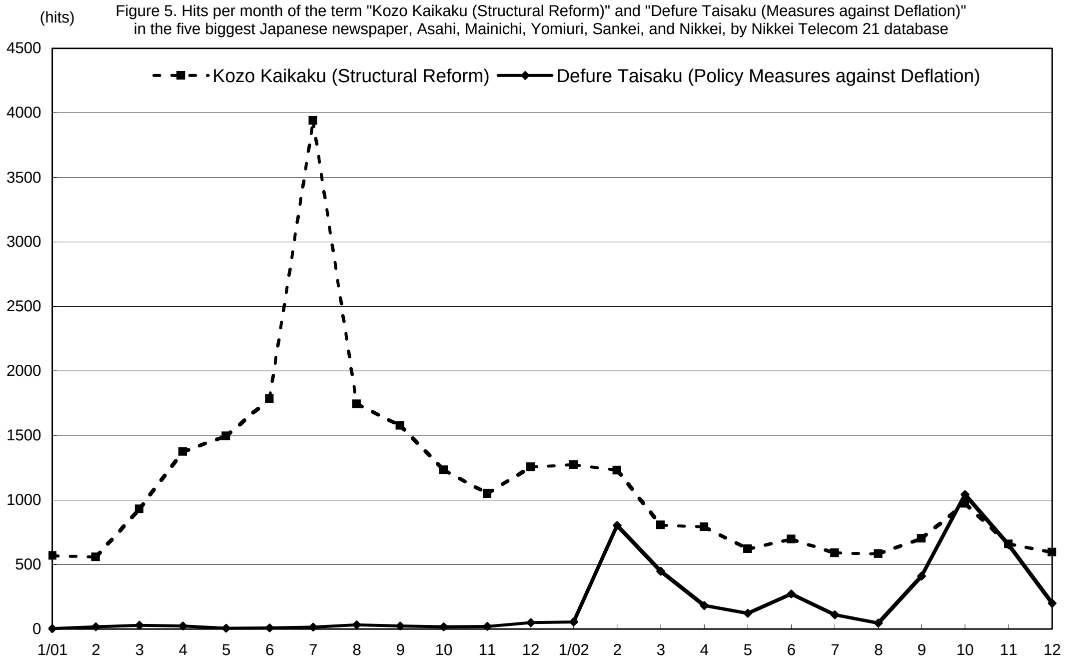


Table 1. The number of editorial articles from 2000 to 2003 that contain the word "Defure (Deflation)"

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