

By Laurence Norman
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NEW YORK -(Dow Jones)- Economists warned Thursday that the Bank of Japan must tread very carefully in tightening policy so as not to imperil that country's economic recovery.

Speaking at a conference on Japan's economic future at Columbia University, Nobel laureate Joseph Stiglitz was the most explicit, saying the bank's decision to start tightening policy earlier this year was "probably premature."

The BOJ raised its overnight benchmark rate to 0.25% in July, bringing to an end years of ultra-easy, zero-interest-rate monetary policy designed to combat a long period of deflation. The BOJ is expected to gradually continue tightening policy over the coming two years, with most expecting the next rate increase sometime in 2007.

Japan's consumer price index is only slightly positive on a year-on-year basis, and the gross-domestic-product deflator - an alternative inflation gauge - is in negative territory. Japan will report its September CPI Friday. It is expected to show 0.3% year-on-year growth.

Stiglitz said the BOJ, like other developed central banks, is paying too much attention to the danger of a long-term increase in inflation and too little focus on growth and full employment.

They have the "wrong objectives...the wrong measures of success and incomplete analysis of the" risks, he said.

He noted that in the past the BOJ has also overestimated the strength of the economy's recovery.

Stiglitz, a former chief economist at the World Bank, also questioned to what extent the economic reforms pushed in recent years have contributed to Japan's recovery.

He said that Japan "has paid a huge price" for the liberalization of its economy and privatization policies, and it is "nonsense" to suggest that these policies - including the much-vaunted privatization of the post office - have turned the economy around.

Stiglitz said that the key reason for Japan's recovery is the emergence of China.

"Japan made some good decisions, one of which was to locate next to China," he quipped.

Stiglitz also said that the massive debt Japan is burdened with "is an intertemporal problem of considerable magnitude" - that is, it's a problem both now and in the future.

Japan's debt is equal to some 150% of the country's GDP - among the highest rate of any industrialized economy.

Music To Japan Government's Ears

Stiglitz received some backing for his worries about the BOJ from other economists at the conference.

R. Glenn Hubbard, the former Chairman of the Council of Economic Advisers

during President George W. Bush's first term, was far more favorable on Japan's economic reforms and more upbeat on the country's long-term prospects, however he also said the BOJ should go slow.

"Japan is not out of the woods by any stretch" of the imagination yet on deflation, and the economy "still hasn't returned to full-employment growth."

"As with comedy, so in monetary policy, timing can be everything. It is the case that Japan needs to normalize monetary policy, but I think it would be a policy blunder to move very quickly. I am very concerned about (Japan's) fiscal policy, but I'm very, very concerned about the possibility of a monetary-policy error."

He said deflation "will continue to have an impact on the economy."

The warnings on BOJ hikes may well be music to the government's ears. The administrations of former Prime Minister Junichiro Koizumi and current Prime Minister Shinzo Abe have called on the BOJ to move very cautiously and have refused to declare a definitive end to the deflation era.

Earlier this week, Hiroshi Watanabe, said he didn't expect the GDP deflator inflation gauge to turn positive before the end of the fiscal year on March 31.

In his comments to the conference, Hubbard also warned that tax hikes could hamper Japan's chances for sustainable growth and said that Japanese governments have little choice other than cutting spending to bring the country's huge debt burden under control.

Meanwhile, Takatoshi Ito, economics professor at Tokyo University and a member of the Abe government's Council on Economic and Fiscal Policy, also said the BOJ shouldn't rush into rate hikes.

Ito said it seems that Japan's equilibrium real interest rate is still around zero.

"The inflation rate is still low and the recovery is still not in full force...so businesses are not investing in full force, consumers are not spending in full force, so the interest rate is still low."

Noting that "deflationary forces are still at large," Ito nonetheless said that if economic growth continues over the next couple of years, "inflation will go up and interest rates will go up probably faster."

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