

Kazumasa Iwata: The conduct of monetary policy under the new framework

Excerpts of a speech by Mr Kazumasa Iwata, Deputy Governor of the Bank of Japan, at a meeting with business leaders, Akita, 8 June 2006.

* * *

The conduct of monetary policy

The Bank of Japan terminated the quantitative easing policy in early March 2006, and is in the process of reducing the outstanding balance of current accounts held by financial institutions at the Bank. The outstanding balance, which was at around 30 to 35 trillion yen at the time of the termination, is currently at around 12 trillion yen.

Some market participants take the view that the pace of reduction may be too fast, and speculate that this may reflect the Bank's intention to raise the target for interest rates at an early date. Market participants expect the Bank to raise the target for interest rates at some point during fiscal 2006, and this expectation has been factored into current market rates.

The Bank, however, noted when the quantitative easing policy was terminated that it would take a few months before the outstanding balance declined to a level near the reserve requirement. The Bank's money market operations have been in line with this policy statement, and the Bank has not been accelerating the pace of reduction in order to raise the target for interest rates at an early date. It has been some time since money market transactions were conducted under normal market conditions, so that some rates have risen due to trading friction. Nevertheless, on the whole the Bank's reduction of the outstanding balance has been carried out in a stable manner.

New framework of monetary policy and policy implementation

The conduct of monetary policy is now based on the new framework announced in March this year and on the findings from examining the risks affecting the economic outlook that are described in the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report).

Under the quantitative easing policy, monetary policy was conducted with an emphasis on the underlying trend of the core consumer price index (CPI). To be more specific, with the overnight call rate at virtually zero percent, the Bank made a commitment to maintain the quantitative easing policy until the year-on-year rate of change in the core CPI registered zero percent or higher on a sustainable basis in order to affect market expectations of the future path of interest rates.¹ This effect is referred to as the policy duration effect.

The effectiveness of the quantitative easing policy has been the focus of much debate and criticism. I believe, however, that ultimately the policy achieved its initial aims, although this took some time.

There are two reasons for this success. First, the commitment by the Bank to maintain the quantitative easing policy until the core CPI registered zero percent or higher on a sustainable basis provided an anchor for stabilizing expectations concerning future price movements.

Second, the commitment to maintain the policy helped keep relatively long-term rates as well as short-term rates at low levels by affecting expectations regarding the future path of interest rates. As a result, the burden of firms' debt was lightened, facilitating business restructuring. This restructuring increased the effectiveness of resource allocation, leading to improvements in productivity and corporate profitability, and ultimately pushed up the potential growth rate. In short, the combination of low market interest rates and the increased rate of return on corporate nonfinancial assets acted as

¹ The significance of modern monetary policy is more in its ability to influence market participants' expectations of future policy interest rates than in the effects of changes in the policy rate itself. Mervyn King, Governor of the Bank of England, has referred to this phenomenon, in which the effectiveness of monetary policy is enhanced by movements in market interest rates that considerably exceed those in policy rates, as the "Maradona theory of interest rates." The name derives from Argentine football legend Diego Maradona who, in the 1986 World Cup match against England, ran 60 yards in a straight line before placing the ball in the English goal. Maradona was able to run straight for the goal because the English defenders were expecting sudden darting feints. For more details, see M. King (2005), "Monetary Policy: Practice Ahead of Theory," Mais Lecture 2005.

the basic mechanism pushing the rate of change in the core CPI above zero percent.² It goes without saying that the Bank's ample provision of liquidity played a complementary role in stabilizing financial markets and keeping interest rates low.

The quantitative easing policy was at times criticized as being extremely risky, being likened to driving with one's eyes on the rearview mirror because the Bank relied on a price index, a lagging indicator, in conducting monetary policy.

The Bank did not rely solely on the rearview mirror, however. In October 2003, the Bank provided a detailed description of its commitment to maintaining the quantitative easing policy. One of the conditions underpinning the commitment was that the Bank needed to be convinced that the prospective core CPI would not once again drop below zero percent after terminating the policy.

Following the introduction of a new framework in March, the Bank disclosed the Policy Board members' understanding of what constitutes "medium- to long-term price stability" in numerical terms. The distribution ranged between the rate of year-on-year change in the CPI of zero and 2 percent, with most members' median figures falling around 1 percent.

It is important to note here that the "understanding of medium- to long-term price stability" was not kept within the Policy Board but was disclosed to market participants and made common knowledge. In this way, the information could become a focal point of market interest and function as a catalyst in forming a consensus concerning inflation expectations.³

With the change in the framework, the policy anchor for price stability shifted from the commitment in terms of policy duration to the Policy Board's "understanding of medium- to long-term price stability." Furthermore, in light of the "understanding of medium- to long-term price stability," the Bank decided to examine periodically the risks facing the Japanese economy, both in the short term (one to two years) and in the medium to long term, using the findings to formulate its thinking on the future conduct of monetary policy. The Bank is thus able to implement short-term policy in a flexible and timely manner based on due assessment of economic risks.

Returning to the metaphor of driving a car, the degree of divergence in the opinions of Policy Board members regarding the destination has been made clear (increased transparency), and the Bank is back to conventional driving with a close eye on the risks ahead, ready to react quickly when necessary.

The new framework can be said to ensure transparency as well as timeliness and flexibility in two senses.

First, disclosing the Bank's thinking concerning medium- to long-term price stability has enhanced the transparency of its policy conduct, making it possible to conduct short-term monetary policy with increased flexibility.

Second, given the fact that Japan's economy is in transition away from deflation and that structural changes continue to take place in the economy, a review of the Policy Board's "understanding of medium- to long-term price stability," to be conducted once a year as a rule, will enable a more flexible response to changes in the economic outlook and ensure the transparency and flexibility of the Bank's monetary policy.

In short, the new framework has articulated specific measures for realizing the principle of monetary policy stipulated in Article 2 of the Bank of Japan Law: to contribute "to the sound development of the national economy" "through the pursuit of price stability."

² Twentieth century Swedish economist Knut Wicksell developed the theory that when the actual market rate of interest exceeds the natural rate of interest (the rate at which the supply and demand for real capital are in equilibrium) deflation accelerates, while inflation accelerates when the opposite occurs.

³ Two game theorists who were awarded the 2005 Nobel Prize in Economic Sciences emphasized the possibility that common knowledge could generate consensus building. This is because common knowledge, by becoming a focal point for people's interest, has the potential to alter their behavior. For more details, see K. Iwata and M. Fukao (1995), "*Keizai Seido no Kokusaiteki Chousei* (International Adjustment of Economic Systems)," Nihon Keizai Shimbun, Inc.; T. Schelling (1960), "The Strategy of Conflicts," Harvard University Press; and R. Aumann (1976), "Agreeing to Disagree," *Annals of Statistics*, 4.

The key point here is that by stabilizing inflation expectations in the medium to long run, flexibility in conducting monetary policy in the short run has been increased, and this in turn has made it easier to achieve the objective of sustainable growth under price stability.

The "understanding of medium- to long-term price stability" is different from the Bank of England's inflation target or the European Central Bank's quantitative definition of price stability, and is an important first step toward the optimal monetary policy for realizing the principle stipulated in Article 2 of the Bank of Japan Law.

The policy interest rate – the basis for producing forecasts

In the most recent Outlook Report, the economic forecasts of Policy Board members were made taking account of market participants' expectations of future policy rates, which were deduced from market interest rates.⁴ Under the quantitative easing policy, it was natural to base forecasts on the assumption that the policy interest rate would be constant until at least the year-on-year rate of change in the core CPI registered zero percent or higher on a sustainable basis. Under the current framework, however, this assumption would be rather unnatural. Prices of assets, such as stocks and land, incorporate expected future movements in interest rates. Therefore, the assumption of constant interest rates would generate a forecast based on asset prices that differ from those currently observed. It goes without saying that ignoring actual asset prices when making forecasts is highly counterintuitive.

This does not of course imply that Policy Board members base their economic forecasts directly on the market's forecast of the policy interest rate. Mechanically adopting market forecasts of interest rate developments in conducting monetary policy and preparing forecasts might cause economic and price developments to diverge from the Bank's desired path. The new method does, however, take into account market expectations in making economic forecasts, and thus its adoption is another important step toward achieving an optimal monetary policy.

Conclusion

Against a background of high crude oil prices, major countries around the world are in the process of economic adjustment, aiming for a soft landing near the potential growth rate while maintaining stable prices. Financial markets around the world also are making adjustments, reflecting changes in the economy as they seek a new equilibrium. The Japanese economy has so far been moving in line with the forecast described in the April Outlook Report. Although various risks lie ahead, Japan's economy is likely to achieve sustainable growth under price stability. I believe, however, that in order to make this happen, it is vital that monetary policy is implemented appropriately so that the full potential of the new policy framework can be realized.

⁴ In making forecasts, assumptions about the policy interest rate fall into three classes. In the first, a constant interest rate path is assumed. In the second, the interest rate path is assumed to be in line with market expectations. And in the third, interest rates are assumed to follow the optimal path projected by the central bank based on the information available to it. The Bank of England carries out forecasts using the first two approaches. The third approach is adopted by the central banks of New Zealand and Norway. For more details on Norway, see J. F. Qvigstad (2005), "When Does an Interest Rate Path 'Look Good'? Criteria for an Appropriate Future Interest Rate Path."