Toshihiko Fukui: Inflation dynamics and monetary policy

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the International Conference on Inflation Dynamics, hosted by Hitotsubashi University, Tokyo, 28 June 2007.

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It is my great pleasure to be invited to speak before such distinguished economists from both Japan and overseas. The theme of this conference, "Inflation Dynamics," is, without any question, one that cannot be ignored by any central banker pursuing the most desirable monetary policy. Presumably it is the interest in a central banker's perspective on this key topic that explains why I have been given the privilege of speaking to you today. Accordingly, I would like to take this opportunity to give my thoughts on the subject.

The issue of inflation dynamics has been studied for a long time, yet remains as relevant today as ever. The year I joined the Bank of Japan, 1958, was the year when the seminal paper by Professor Alban W. Phillips was published. Half a century on, the basic idea behind the Phillips curve has been considerably extended, and many related theories have evolved in connection with the role of expectations, the mechanisms that bring about price rigidity, and so forth.

For monetary policy to achieve its objective of price stability, it is extremely important to accurately understand the dynamics of inflation. These dynamics, however, may change along with changes in the economic structure, and it is often difficult to detect such changes in a timely manner. This often becomes a source of anxiety to central bankers conducting monetary policy in the real world. In recent years, especially, the biggest challenge facing central bankers may be the conduct of monetary policy in the face of the flattening of the Phillips curve and increase in uncertainty with regard to inflation dynamics.

With a flatter Phillips curve and given a situation where the inflation rate is within the desirable range, small economic fluctuations will not cause the inflation rate to shift outside the range. On the other hand, a flatter Phillips curve means that, once inflation shifts outside the range, bringing it back is that much harder, since the output gap or the change in the output gap necessary to raise or lower the inflation rate becomes correspondingly larger.

For example, in the United States, Governor Mishkin of the Federal Reserve Board, in his speech delivered in April, stated that "returning inflation too quickly to levels consistent with price stability might unnecessarily exacerbate the economic weakness. Instead, while restoring price stability remains critical, the central bank should do so at a pace that does not do undue harm to the economy."

In Japan, we are experiencing a similar problem, although the direction is quite the opposite. Japan's economy has been growing at a rate above its potential for some time. Utilization of resources such as production capacity and labor has been increasing, and the estimates of the output gap are suggesting tighter supply and demand conditions. On the other hand, the response of prices to this situation has been very weak, leaving the current inflation rate near 0 percent. In a situation like this, the extent of the output gap needed to raise the inflation rate in a short period of time becomes not only very large but also subject to significant uncertainty. An abrupt widening of the output gap may bring about larger swings in the economy and risk the sustainability of the economic expansion. The alternative, safer route is to focus on securing sustained economic growth and minimizing swings, generating corresponding expectations of a moderate and gradual rise in the inflation rate. As you might expect, it is this latter approach that is behind the Bank of Japan's current gradual adjustments in the level of interest rates.

Historically, inflation dynamics have often exerted considerable influence on central banks' policy frameworks and their conduct of monetary policy. Experience of high inflation up to the 1980s, for example, encouraged the development of monetary policy frameworks focusing on prices, such as "inflation targeting" regimes. Since then, prices have tended to stabilize and the Phillips curve has become flatter. Such changes in inflation dynamics have made it necessary for central banks to look at the broader picture in their pursuit of price stability. To be more specific, with a flatter Phillips curve, imbalances in the economy do not easily translate into movement in prices. On the contrary, it is possible that imbalances may make themselves felt on the real side of the economy or in asset prices before they are translated into instability in general prices. This has indeed induced central banks, including those that have adopted inflation targeting, to gradually shift their attention to achieving price stability in the longer run through flexibly responding to economic developments as well as prices. The framework for the conduct of monetary policy that the Bank of Japan adopted when it terminated the quantitative easing policy in March 2006 was constructed with these inflation dynamics in mind, and in full awareness that they may evolve further in the future.

As I just mentioned, inflation dynamics may change in the future, and such uncertainty is another crucial point that should be taken into consideration in the conduct of monetary policy. Specifically, no one knows whether the flattened Phillips curve will be a lasting phenomenon. In our Outlook Report published in April, we pointed out that the shape of the Phillips curve may change along with changes in inflation expectations or labor cost restraint by firms. Moreover, there is more than one hypothesis competing to explain the flattening of the Phillips curve: for example, some point to decrease in firms' control over prices as a result of the stiff competition following deregulation and globalization, while others refer to the decreasing frequency of price revisions by firms in response to disinflation. Inevitably, the outlook for the future differs depending on the hypothesis favored.

Actual economic developments always entail uncertainty, and not only for the reasons I just stated. Just as with other economic challenges, a final resolution to the problems posed by inflation dynamics may be too much to ask for. Yet in spite of this, central bankers must keep up with the cutting-edge ideas and insights of their time and reflect them in their policy management. As one such central banker, I am very much looking forward to seeing our understanding of inflation dynamics deepened thanks to the research efforts stimulated by conferences such as this.

Thank you very much for your attention.