Haruhiko Kuroda: Quantitative and qualitative monetary easing

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at a meeting held by the Yomiuri International Economic Society, Tokyo, 12 April 2013.

*   *   *

Introduction

It is a great honor to be invited to this meeting hosted by the Yomiuri International Economic Society today. This is my first speech as Governor of the Bank of Japan. Today, I would like to explain the “Quantitative and Qualitative Monetary Easing” that we decided to embark on last week.

I. Basic thinking

When I was appointed as the governor, I had the following basic thinking in mind.

The first is that we should do whatever is necessary to overcome deflation, which has been causing a deterioration in Japan’s economy for nearly 15 years. The Bank of Japan has engaged in a wide range of monetary easing efforts – including the implementation of the zero interest rate policy, the quantitative easing policy, and comprehensive monetary easing. Despite its cumulative efforts, there have been no easily derived concrete results, and I have felt strongly that we should make all-out efforts to utilize every possible resource bestowed upon the Bank, rather than to adopt an incremental approach – or, put differently, to adopt gradualism.

The second point is the importance of committing strongly and clearly that the Bank is responsible for achieving the price stability target. At the Monetary Policy Meeting held in January, the Bank – on its own judgment – set the price stability target at 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI) and made a groundbreaking commitment to achieve that target at the earliest possible time. Regarding the time frame for achieving the target, looking at other economies, many central banks have been making efforts to achieve the price stability in the medium term, with a time horizon of about two years for the effects of monetary policy to permeate the economy. I have found it appropriate for Japan’s economy as well to make a commitment with a time horizon of about two years.

The third point is to convey the Bank’s strong policy stance to markets and economic entities with clarity and intelligibility, thereby dramatically changing the expectations of market participants as well as firms and households. During the course of 15 years of deflation, the public’s behavior has been based on the assumption that prices would either decline or be unlikely to rise. It is necessary to eliminate deflationary expectations through the Bank’s strong commitment and intelligible explanation.

And lastly, we should enter a new phase of monetary easing both in terms of quantity and quality in order to underpin such a commitment. There is a reason to emphasize the qualitative aspect of monetary easing along with its quantitative aspect. While the Bank of Japan and other central banks in advanced economies have almost exhausted further declines in short-term interest rates, they now engage in policies to increase the size of their balance sheets as part of unconventional policy measures. There is now a broad consensus with regard to the effect of balance sheet expansion. That is, the central banks’ purchases of government bonds and other assets from the markets have the effect of encouraging further declines in long-term interest rates and lowering risk premia of asset prices by absorbing risks – such as the one stemming from interest rate fluctuations. Consequently, it becomes important to determine not only how much liquidity to supply but also how to supply that quantity. Even with the same amount of liquidity, purchasing short-term T-Bills produces different effects than in the case where the Bank purchases other assets such as long-term

JGBs and risk assets like exchange-traded funds (ETFs). Thus, it is important to work on two aspects of monetary easing, both in terms of quantity and quality.

II. Introduction of the "Quantitative and Qualitative Monetary Easing"

With this basic set of views, I assumed the governorship and attended the Monetary Policy Meeting on April 3 and 4. Following discussion with other Policy Board members and taking into account the staff view regarding practicalities, we came to a conclusion. The name of the quantitative and qualitative monetary easing that we introduced this time speaks for itself. This is indeed a new phase of monetary easing both in terms of quantity and quality.

Strong and clear commitment

First, the Bank decided – as I mentioned earlier – to convey a strong and clear commitment. The Bank clearly announced in a statement that "[it] will achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI) at the earliest possible time, with a time horizon of about two years." This is the decision of the Bank's Policy Board – namely, it expresses the will of the Bank as an institution.

New phase of monetary easing both in terms of quantity and quality

Next, the Bank decided to embark on the quantitative and qualitative monetary easing as a means to underpin this commitment.

Concretely, with a view to pursuing quantitative monetary easing, the Bank decided to change the main operating target for money market operations from the uncollateralized overnight call rate (i.e., interest rates) to the monetary base (i.e., quantity) and conduct money market operations so that the monetary base will increase at an annual pace of about 60–70 trillion yen. The monetary base is the currency supplied to the economy as a whole by the Bank; more specifically, it is the sum of banknotes and coins in circulation and financial institutions' current account deposits at the Bank of Japan. As of end-2012, its amount outstanding was 138 trillion yen, and it is expected to reach about 200 trillion yen at end-2013 and 270 trillion yen at end-2014. It will almost double in two years. This accounts for nearly 60 percent of nominal GDP, far above the levels of any other advanced economies.

As a means to increase the monetary base, the Bank decided to purchase JGBs so that its holding of their amount outstanding on the Bank's balance sheet will increase at an annual pace of about 50 trillion yen. Consequently, the Bank's holding of JGBs will be increased from 89 trillion yen at end-2012 to 190 trillion yen at end-2014. In short, it will more than double in two years. The monthly flow of JGB purchases is expected to become 7+ trillion yen, because the Bank needs to compensate for JGBs redeemed.

In terms of quality, in increasing the purchases of JGBs, those with all maturities including 40-year bonds will be made eligible for purchase, and the average remaining maturity of the Bank's JGB purchases will be extended from slightly less than three years at present to about seven years – equivalent to the average maturity of the amount outstanding of JGBs issued. We intend to strengthen the working of monetary easing on the economy and prices by encouraging a further decline not only in shorter-term interest rates but also in those across the yield curve. Furthermore, with a view to lowering risk premia of asset prices, the Bank will purchase ETFs and Japan real estate investment trusts (J-REITs) so that their amounts outstanding on the Bank's balance sheet will increase at an annual pace of about 1 trillion yen and about 30 billion yen, respectively.

Intelligible monetary policy

In the implementation of the quantitative and qualitative monetary easing, as mentioned earlier, we have taken account of the need to present our policy stance intelligibly to markets as well as firms and households.

Until last week, the Bank's purchases of JGBs had been conducted according to the following two types of operations: one under the Asset Purchase Program introduced in October 2010 and the other for facilitating money market operations, often referred to as *Rinban* operations. This reflects the Bank's various efforts to tackle challenges in response to changes in economic circumstances. In fact, these types of operations, reflecting their objectives, had differed in terms of the purchasing methods used. However, this framework was somewhat complicated and entailed a problem that the Bank's serious efforts to combat deflation by monetary easing were rather difficult for the market and the public to understand. Based on such recognition, the Bank has terminated the Asset Purchase Program and synthesized purchasing methods of JGBs. Moreover, it has decided to express the target of JGB purchases as a net increase in its JGB holdings – namely, at an annual pace of about 50 trillion yen. We believe that these changes will facilitate understanding of the Bank's intention with regard to monetary easing in a straightforward manner.

As I mentioned earlier, the Bank decided to adopt the monetary base as an indicator for quantitative easing. This also reflects our judgment that the monetary base – the total amount of currency that the Bank supplies to the economy as a whole – will be the most appropriate indicator for conveying the Bank's aggressive stance on monetary easing to the public.

Continuation of monetary easing

The Bank will continue with the quantitative and qualitative monetary easing that I have explained thus far, "aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner." Obviously, there will be both upside and downside risks to economic activity and prices going forward. The Bank will examine those risks carefully and will not hesitate to make adjustments as appropriate, should circumstances warrant.

One may ask, why is there a connection between what I have just mentioned and a time horizon of about two years? In our view, the latest decisions include all the necessary measures to achieve the 2 percent target with that time horizon. Nonetheless, it is not appropriate to say that the monetary easing will only last for two years. The economy entails uncertainty, and there is always a degree of latitude in people's expectations; for example, some people may not share the view that the inflation rate will reach 2 percent in two years. For everyone – including those who are somewhat skeptical – to be convinced that sufficient monetary easing will be implemented, it is appropriate to state that the Bank will continue with monetary easing, aiming to achieve the price stability target of 2 percent, "as long as it is necessary." Making such a commitment will, in the end, further ensure the achievement of the target in two years.

I also want to elaborate on the meaning of "as long as it is necessary." The Bank does not believe 2 percent inflation achieved at a certain point in time is enough; rather, it believes 2 percent inflation should be maintained in a stable manner. Therefore, even if the inflation rate hits 2 percent at some point, the Bank could continue with the quantitative and qualitative monetary easing if it is judged necessary to do so in order to maintain that rate in a stable manner. The opposite could also be true. In short, analyzing the fundamental movement of prices, the Bank intends to continue with monetary easing, as long as it is necessary.

III. Effects of the "Quantitative and Qualitative Monetary Easing"

Transmission channels of monetary easing effects

I will next explain the mechanism of achieving the 2 percent target under the quantitative and qualitative monetary easing. The Bank expects that the effects of monetary easing will permeate the economy and influence prices primarily through three channels.

First, the purchases of JGBs, ETFs, and J-REITs will encourage a further decline in longer-term interest rates and lower risk premia of asset prices. This will raise firms' credit demand through a decline in funding costs. Second, as a result of the Bank's massive purchases of JGBs, both investors and financial institutions investing in JGBs are expected to shift from JGBs to such risk assets as stocks and foreign-denominated bonds and/or to increase lending within their portfolios. In economic textbooks, this is referred to as a portfolio rebalancing effect. The extension of the average remaining maturity of JGB purchases reflects our understanding of such an effect. Third, the commitment to achieve the price stability target at the earliest possible time and the continuation of the new phase of monetary easing are thought to drastically change the expectations of markets and economic entities. This is what I referred to earlier as the elimination of deflationary expectations. A rise in the expected inflation rate will not only influence actual prices but also stimulate private demand through a decline in real interest rates.

Developments in economic activity and prices

Looking at recent developments in economic activity and prices, it seems that the conditions are being prepared to demonstrate the effects of the quantitative and qualitative monetary easing through the three transmission channels that I just mentioned. Indeed, Japan's economy has shown some bright signs of picking up. Going forward, we expect the economy to return to a moderate recovery path against the background of firm domestic demand and a pick-up in growth rates of overseas economies. In recent months, conditions in financial markets have significantly turned favorable due to the abatement of global investors' risk aversion and expectations for domestic policies.

The year-on-year rate of change in the CPI has recently been at around 0 percent or slightly negative, but looking to the future, it is expected to turn positive and start picking up, mainly reflecting the improvement in the aggregate demand and supply balance. Looking at breakeven inflation rates – using the information content in inflation-indexed bonds – and the results of economists' and households' surveys, we have increasing evidence that inflation expectations are starting to rise. Behind this are expectations for policies including monetary policy. This indicates that policies can move expectations.

The Bank expects that the quantitative and qualitative monetary easing will support, in a timely manner, the positive movements that have started to appear in economic activity and financial markets, contribute to a further pick-up in inflation expectations that appear to have risen, and lead Japan's economy to overcome deflation that has lasted for nearly 15 years.

IV. Some points of discussion in the monetary policy conduct

After the announcement of this time's decision, some wonder if the Bank can carry out the quantitative and qualitative monetary easing while others say that it has gone too far. In addition, we often receive questions about the relationship between monetary policy and other policies conducted by the government. In the final part of my remarks, I wish to answer some of these questions.

Execution of the quantitative and qualitative monetary easing

The newly planned purchase of JGBs at an annual pace of 50 trillion yen is massive and goes beyond the conventional knowledge of market participants. In addition, the achievement of the monetary base of 270 trillion yen at end-2014 requires that financial institutions' current account balances held at the Bank reach 175 trillion yen. Again, this is extremely large. Furthermore, the extension of the average remaining maturity from slightly less than three years to about seven years (i.e., allowing for a range of about six to eight years) necessitates the purchases of JGBs with longer maturity, including 20- and 30-year bonds. Such JGBs with super-long maturities are likely to be held to maturity by institutional investors and their market is not so active. Against this background, some market participants wonder if the Bank is able to purchase these JGBs in practice.

To answer this question, we can do this, in principle, so long as the Bank purchases a wide range of JGBs through a competitive auction. I assure you that we will achieve our commitment. Having said so, however, such purchases by the Bank might not proceed smoothly because they go beyond the market's convention. To start with, these measures are meant to encourage a further decline in interest rates; thus, effects on the market are inevitable to some extent. As the Bank wants to facilitate such operations, it is vital to have the cooperation of market participants, such as counterparties' active bidding in the Bank's market operations. The Bank has decided to set forums for enhanced dialogue with those market participants in order to exchange views pertaining to money market operations and market transactions in general. In fact, it has already initiated such dialogue with various market participants since last week.

Relationship with financing the fiscal deficit

Once the Bank embarks on the large-scale purchase of JGBs under the quantitative and qualitative monetary easing, some worry that this will result in financing the fiscal deficit. The JGB market remains stable, but if such purchases by the Bank were regarded as monetizing government debt, the JGB market might start destabilizing, raising long-term interest rates in a manner inconsistent with the real economy. This might not only offset the monetary easing effects but also have negative effects on Japan's financial system and its economy as a whole.

Of course, the JGB purchases under the quantitative and qualitative monetary easing are executed for the purpose of conducting monetary policy and not for the purpose of financing fiscal deficits. Moreover, in order to avoid a possible arousal of doubt regarding the Bank's increasing purchases of JGBs as financing fiscal deficits, it is vital for the government to clearly show the future course of fiscal consolidation and steadily make progress to reform the fiscal structure. On this point, the government – in the joint statement released with the Bank in January – stated that "in strengthening coordination between the Government and the Bank of Japan, the Government will steadily promote measures aimed at establishing a sustainable fiscal structure with a view to ensuring the credibility of fiscal management." We strongly expect the government to move on that front.

Because the Bank synthesized the purchasing methods of JGBs this time, it temporarily suspended the so-called banknote principle. This principle indicates that the purchases of JGBs conducted for facilitating money market operations are subject to the limitation that the outstanding amount of long-term government bonds effectively held by the Bank be kept below the outstanding balance of banknotes issued. In reality, however, after the introduction of the Asset Purchase Program in 2010, the total amount outstanding of JGBs held by the Bank has already exceeded the outstanding balance of banknotes. Based on this recognition, the Bank has decided to temporarily suspend the banknote principle as it pursues the quantitative and qualitative monetary easing. In any case, let me reiterate that the Bank will not finance the fiscal deficit during or after the period of the quantitative and qualitative monetary easing, and this line of thinking will not change.

Effect on exchange rate

We also hear comments about the relationship between monetary policy and exchange rates against the background of the recent depreciation of the yen. On this point, we have no intention to conduct monetary policy targeting the exchange rate. The objective of the Bank's monetary policy is, obviously, to pursue the stability of domestic prices.

It is true that, when a central bank takes accommodative actions, there is a tendency for its country's currency to depreciate. This, however, is merely a general observation, ceteris paribus. For instance, if the growth potential of the economy rises as a result of monetary accommodation as well as appropriate fiscal policy and the growth strategy, its currency could appreciate rather than depreciate.

In any event, the Bank’s monetary policy is focused on achieving the domestic objective to lead Japan’s economy toward overcoming deflation. Achieving this goal will eventually provide the global economy with favorable effects. I believe that the international community shares a common understanding on these points.

Three-pronged strategy (three arrows)

At present, the government is determined to address challenges that Japan’s economy faces, including the overcoming of deflation, through the combination of three policy arrows – namely, bold monetary easing, flexible fiscal policy, and a growth strategy that promotes private investment. I think it is indeed an appropriate policy package. Achieving the price stability target of 2 percent at the earliest possible time, through the first arrow (i.e., monetary easing) is the role of the Bank of Japan. As I have explained to you today, the Bank will achieve this target under its own responsibility.

In addition, parallel to monetary easing, if the government creates real demand and wages and employment improve through the expansion of consumption and investment, this is expected to contribute to generating a virtuous cycle that eventually will lead to a gradual pick-up in inflation. It is in this sense that the implementation of the other two arrows – namely, flexible fiscal policy for the time being and a growth strategy – will lead to raising the growth outlook, thereby contributing to the achievement of the price stability target more smoothly. We have high expectations that the government will make steady progress on these fronts.

Concluding remarks

For eight years before assuming the position of Governor of the Bank of Japan, I looked at Japan from overseas as President of the Asian Development Bank. No other country has suffered from deflation for nearly 15 years. Given that Japanese financial institutions, firms, and individuals play active roles in each Asian economy, I have often found it hard to accept the contrasting image at home and abroad.

The world is eagerly waiting for Japan to overcome deflation and for Japan’s economy to recover its economic strength. I believe steady efforts toward achieving these goals will also lead Japan toward regaining its influence on the global society.

Thank you.