Toshiro Muto: Battle against deflation

Speech by Mr Toshiro Muto, Deputy Governor of the Bank of Japan, at Japan Society, New York, 26 September 2003.

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Thank you, Mr. Wheeler.

Good afternoon, ladies and gentlemen. It is a great honor to be here and address Japan Society.

Today I focus on the Bank of Japan's on-going battle against deflation.

Japan's core Consumer Price Index, which is the Consumer Price Index excluding volatile food, has been going down for the past five years, and the Bank of Japan has been fighting against this deflation.

The Bank of Japan adopted the so-called "zero interest rate policy" in February 1999. After reducing the short-term policy interest rate from 6 percent in 1990 to 0.5 percent in 1995, the Bank decided to push it down to virtually zero by providing ample liquidity in the market.

This policy was unprecedented in the history of central banking. In the 20th century, the lowest official discount rate was 0.5 percent in the United States between 1942 and 1946, and also in Switzerland in 1999.

In March 2001, the Bank adopted the "quantitative easing" framework. In spite of extremely low interest rates, "Japan's economy had failed to return to a sustainable growth path, and was faced again with the threat of deterioration." In its monetary operations, the Bank shifted the operating target from the short-term policy interest rate to the outstanding balance of current accounts at the Bank.

So far, from our experience over the last two and a half years, quantitative easing has been effective in stabilizing the financial markets. It has worked to avert a credit crunch, and facilitate corporate funding. Through these channels, it has been supporting economic activity.

The quantitative easing framework has three key pillars.

The first pillar is that the Bank of Japan is providing the current account balances of financial institutions with ample liquidity. In fact, the amount of these current account balances is more than five times the required reserves. The base money, which is the sum of these current account balances and banknotes in circulation, has increased more than 60 percent in the past two and a half years.

Reflecting such an increase, the balance sheet of the Bank of Japan has expanded significantly. The size of the Bank's balance sheet relative to GDP had been stable around 10 percent for the past 50 years, but now it is close to 30 percent.

Naturally, with the provision of such ample liquidity in the market, short-term interest rates are held down virtually at zero. Despite ample liquidity we provide in the market, nominal interest rates cannot decline below zero. This is called the constraint of zero interest rates, which I will touch on later.

The second pillar is that the Bank is committed to continuing with the current policy framework until the core Consumer Price Index shows zero percent or above on a year-on-year basis in a stable manner.

This commitment tends to reduce medium-term interest rates along the yield curve. It creates the expectations among market participants that the current extra easy monetary policy will continue for a considerable period. It reduces the level of expected future short-term interest rates and the uncertainty about the future path of these rates. This effect of precommitment policy is sometimes called the "policy duration effect."

The third pillar is that the Bank is conducting the outright purchase of long-term government bonds as a means of providing ample liquidity in the market. The monthly purchase now is about 10 billion dollars.

Deflation is not necessarily new. Indeed, we observe a couple of deflation periods in the past. In Japan, prices declined by about one third during five years in the 1880s. In the United States, prices fell by a quarter in three years in the 1930s during the Great Depression.

For a little more than fifty years after World War Two, however, we had hardly experienced deflation. And, central banks had been mainly concerned with prices "going up" rather than prices "going down," and worked hard to put inflation under control.

I still remember that the Federal Reserve was very concerned about inflation while I was working at the Japanese Embassy in Washington, D.C. for three years from 1975 through 1978.

Around that time, the world economy was suffering from stagflation after the oil crises, and the United States, Germany and Japan were pressured to play the role as the "locomotive" of world growth.

Thanks to the prudent conduct of monetary policy and such dramatic changes as the entry of emerging countries into the market economy, inflation has been gradually slowing down since the 1990s. And now, we have entered the period of global disinflation.

Japan is currently in mild deflation after passing a disinflationary stage. The core Consumer Price Index is now around minus 0.1 percent on a year-on-year basis following the decline of a little less than 1 percent in the past two years. The extent of deflation in Japan is much smaller than that during the Great Depression, which was well over minus 10 percent.

In addition, Japan is suffering from the burst of asset price bubbles in the late 1980s. Asset prices fell dramatically. Now, stock prices are one-third of the peak, and real estate prices are about a quarter of the peak during the bubble period. Although stock prices are rising recently, real estate prices are still falling. Asset price deflation, the decline in real estate prices in particular, is making a greater negative impact on the banking sector than the falling prices in goods and services.

As Japan is the only one among industrialized countries that suffers from the decline in both the general price level and asset prices, the Bank of Japan is the front runner in the fight against deflation among central banks around the world. Under such circumstances, the Bank has been, and will be innovative in the conduct of monetary policy.

One unconventional policy measure is the purchase of risk assets, such as asset-backed securities and corporate stocks.

The Bank now purchases asset-backed securities, or ABS for short, with corporate obligation as the underlying asset. We hope the ABS market will grow with our purchase as a catalyst, and that it will help strengthen the weakened transmission mechanism of monetary policy.

As businesses rely heavily on banks for their funding in Japan, it is an important policy agenda to expand the channels of financial intermediation, such as the ABS market, which are not vulnerable to banks' risk-taking capability.

With a view to strengthening banks' intermediation function, the Bank of Japan purchases corporate stocks held by commercial banks. This is also an unconventional measure for a central bank.

In Japan, due to cross-shareholdings between banks and businesses, some large banks hold a substantial amount of corporate stocks. Because of these holdings, banks are exposed to the impact of stock market volatility on their balance sheets, which may constrain their risk-taking capability.

The sale of stocks to the Bank of Japan by commercial banks alleviates the potential negative impact on their financial position and enhances their risk-taking capability.

In the course of taking these unconventional measures, we have learned a number of new things. Among these, let me share with you two of them.

First is the side effect of quantitative easing. Within the quantitative easing framework, the market function is weakening in the money market. Under zero interest rates, market participants with their cautious investment attitude feel little incentive to lend in the money market, and as a result the market is shrinking. We firmly believe that the well functioning market is quite important in the efficient allocation of financial resources, and we do not in any way take such market shrinking lightly.

This side effect, however, is unavoidable in my view. In implementing any policy measure, we need to weigh their effects and side effects against the economic situation. And, we judge that the positive impact of quantitative easing outweighs the side effect of shrinking money market, given the current Japanese economic situation.

Second is how to maximize the precommitment policy effect under quantitative easing. During the period of zero interest rate policy from 1999 through 2000, the Bank announced in its policy statement that it was committed to continuing with the policy until deflationary concerns were dispelled.

Compared with this rather descriptive announcement, the current commitment under quantitative easing is far more concrete and objective. The Bank maintains that it continues with the existing policy until the published data of the core Consumer Price Index show zero percent or above in a stable manner.

The commitment reduces the freedom about the future course of monetary policy. Because of such constraint, the policy impact tends to become more powerful. Compared with the zero interest rate policy, medium-term interest rates under quantitative easing are lower and their volatility is smaller on average.

In fighting against deflation under zero interest rates, we have found that the constraint of zero interest rates on monetary policy is an important issue for central bankers around the world. From our experience so far, it seems that the extent of policy constraint depends very much on the factors shaping the economic and financial situation.

One factor, which influences the effectiveness of policy response under zero interest rates, relates to the banking system and the financial markets. Both the banking system and the financial markets are the transmission mechanism of monetary policy. They need to be sound and efficient for the transmission mechanism to function effectively.

In Japan, at the moment the transmission mechanism is not functioning as is described in the standard textbook. The purchase of risk assets such as ABS and corporate stocks is a policy measure to improve this mechanism. The banking system has not yet fully restored its soundness and stability, and the financial markets have not developed to the degree that they can smoothly provide "multiple avenues of financial intermediation."

The situation is quite different in the United States, where the banking system is sound and the capital markets are well developed.

Another factor, which eases the constraint of policy response under zero interest rates, is room for the use of fiscal policy. Even when the effect of monetary policy is constrained, to beat deflation will be easier if the government can conduct fiscal policy effectively.

In Japan, the question boils down to whether voters can reach a consensus on effective further stimulus. The present stance of the Koizumi Cabinet is that, until fiscal 2006, the size of government expenditure relative to GDP should not exceed the level in fiscal 2002.

In the United States, it is quite a contrast that people have high expectations for the stimulative effect of large federal tax cuts. And, these tax cuts are actually making a visible impact on economic activity.

Although it is perhaps too early to tell that Japan's economy has returned to a solid recovery path, domestic demand, capital spending in particular, is showing signs of improvement. Toward the end of this year, we expect Japan's economy will gradually recover as the very pessimistic outlook for the world economy subsides. The Bank of Japan will continue with the current extra easy monetary policy to give maximum support to the recovery, which appears to be in progress.

Let me briefly mention our thinking on the exchange rate. As was stated in the G7 Statement in Dubai, it is desirable that the exchange rate should reflect economic fundamentals. In the case of Japan, the exchange rate stability is important as it strives to escape from deflation.

The current cyclical recovery in demand may not be enough to conquer deflation. Neither will it alone ensure sustainable growth. In this regard, the importance of structural reforms can never be over-emphasized.

We are making steady progress in structural reforms. For example, a national consensus is being formed on the fiscal reform, and serious discussion is under way about the reform on the social security system. The government takes initiatives to accelerate the resolution of non-performing loans with the target to halve the non-performing loan ratio of major banks by the end of March 2005. The Industrial Revitalization Corporation of Japan, which was established in April this year, is vigorously dealing with corporate restructuring, which helps banks to resolve the non-performing loan problem.

On September 22, Prime Minister Koizumi reshuffled his cabinet after he won the party election. Under the new Cabinet, he reiterated the commitment that he would continue promoting structural reforms aggressively, based on his credo of "no growth without reforms."

The Bank of Japan, for its part, will continue striving to beat deflation and put the economy back on a sustainable growth path by employing all the possible policy measures. Thank you for listening.