Hiroshi Nakaso: Basic idea underlying “Quantitative and qualitative easing”

Speech by Mr Hiroshi Nakaso, Deputy Governor of the Bank of Japan, at the International Conference, organised by the Economic and Social Research Institute, Cabinet Office, Government of Japan, Tokyo, 31 May 2013.

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Introduction

Thank you for giving me an opportunity today to speak at the international conference organized by the Economic and Social Research Institute, the Cabinet Office, the Government of Japan.

I. Introduction of “quantitative and qualitative monetary easing”

Japan’s economy has been in a state of deflation for nearly 15 years. During the period, the economy has been trapped in a vicious cycle. Amid the continued decline in prices, corporate profits and wages were squeezed. Those induced business fixed investment, private consumption, and other economic activity to plunge. As a result, prices fell again. For Japan’s economy to get out of the vicious cycle and recover sustainably, it is critical first to overcome deflation, thereby turning the behavior of economic entities, such as firms and households, positive. In that regard, the biggest challenge Japan’s economy is faced with is to overcome deflation promptly. The Bank of Japan recognizes that its role is critical.

With such recognition, the Bank introduced quantitative and qualitative monetary easing at the Monetary Policy Meeting held at the beginning of April. It aims to achieve the price stability target of 2 percent in terms of the year-on-year rate of change in consumer price index at the earliest possible time, with a time horizon of about two years. With a view to pursuing quantitative monetary easing, the main operating target for money market operations was changed to the monetary base. On that basis, the monetary base and the Bank’s outstanding amount of JGB and ETF holdings will be doubled in two years. The average remaining maturity of the Bank’s JGB purchases has been extended more than twice as long. The policy clearly differentiates itself from the gradualism or incremental approach adopted in the past. Besides, the Bank is committed to continuing with quantitative and qualitative monetary easing, aiming to achieve the 2 percent price stability target, as long as it is necessary in maintaining that target in a stable manner.

As quantitative and qualitative monetary easing requires a massive purchase of JGBs, we need to conduct purchases while monitoring the effects in the bond market. After quantitative and qualitative monetary easing was introduced and in the process of the market digesting its contents, there have been rises in the volatility of government bond yields. The Bank has been having close dialogue more than ever with market participants and taking firm action, including an adjustment of the “parameters” of the JGB purchase operations. Yesterday, the Bank released the outline of the outright purchases of JGBs for the time being. Specifically, it decided to increase the frequency of JGB purchases. While the amount to be purchased was left at approximately 7+ trillion yen per month in principle, it also decided to conduct such purchases in a flexible manner by taking account of market conditions in order to ensure that the effects of monetary policy permeate the economy. The Bank expects that these measures will lead to the stable formation of long-term interest rates by suppressing excessive rise in interest rates and heightened volatility.

II. Outlook for economic activity and prices and the importance of expectations

Let me next explain how the Bank considers economic activity and prices will develop under quantitative and qualitative monetary easing. I will explain in line with the baseline scenario of the "Outlook for Economic Activity and Prices" released by the Bank at end-April.

First, the real economy. Japan's economy has started picking up. As for the outlook, Japan's economy is expected to return to the moderate recovery path around the middle of the year. On the back of that, domestic demand is expected to remain resilient and growth rates of overseas economies will gradually pick up. Thereafter, the economy will be influenced by a last minute surge in demand and its reversal decline at two scheduled consumption tax hikes. Despite that, with a virtuous cycle of production, income, and spending expected to be maintained, the economy is likely to continue growing above the potential growth rate of around 0.5 percent as a trend. Let me quote specific figures from the median of the Policy Board members' forecasts. The growth rate is projected to be 2.9 percent for fiscal 2013, 1.4 percent for fiscal 2014, and 1.6 percent for fiscal 2015. On such growth rate projection, the output gap, which illustrates aggregate supply and demand balance, will gradually turn positive from the current level of about negative 2 percent. It will further widen to about 2 percent in the latter half of the projection period up to fiscal 2015.

As for prices, the year-on-year rate of change in the consumer price index (for all items excluding fresh food) has been negative. Based on the economic projection I have just mentioned, it is expected to be on an uptrend. Main factors behind that are an improvement in aggregate supply and demand balance and a rise in the expected rate of inflation. It is likely to reach the "price stability target" of about 2 percent through the latter half of the projection period up to fiscal 2015. Specifically, the median of Policy Board members' forecasts was 0.7 percent for fiscal 2013, 1.4 percent for fiscal 2014, and 1.9 percent for fiscal 2015.

The Bank's clear commitment to achieving the price stability target and quantitative and qualitative monetary easing that underpins the commitment are expected to lead to a rise in prices through three routes. First, an improvement in aggregate supply and demand balance. When growth beyond the potential growth rate is achieved, aggregate supply and demand balance will improve and the positive output gap will widen. Second, a rise in the medium- to long-term expected rate of inflation. The expected rate of inflation will be on an uptrend under quantitative and qualitative monetary easing and will gradually converge on the price stability target of about 2 percent. Third, an increase in import prices. Foreign exchange rate developments will put upward pressure on those prices for the time being. And on the assumption that international commodity prices will be on a moderate uptrend in tandem with the growth of the global economy, import prices are likely to continue rising.

Of the three, the important key to achieving the price stability target under the current policy is the second route, namely, to raise the medium- to long-term expected rate of inflation. Let me explain the reason by using the so-called Phillips curve, which shows the relationship between aggregate supply and demand balance and the inflation rate. As mentioned, when growth beyond the potential growth rate is achieved, the positive output gap widens. As the gap widens, the inflation rate will rise along the positive slope of the Phillips curve. As deflation has continued for nearly 15 years, the Phillips curve itself has shifted downward. And its slope has become moderate, due partly to a decline in firms' pricing power amid globalization. Given such shape of the current Phillips curve, the 2 percent price stability target cannot be achieved only by achieving a 2 percent positive output gap. One reason for the difference in the outlook for prices between the Bank and private institutions might be that many private institutions have based their outlook on the Phillips curve during the period of deflation. Therefore, to achieve the 2 percent price stability target at the earliest possible time, the Phillips curve needs to be shifted upward by an increase in the expected rate of inflation. Namely, it is necessary not only to improve aggregate supply and demand balance but also to firmly raise the expected rate of inflation by significantly changing "deflationary expectations" of economic agents, such as firms and households. A combination of those two will lead to the achievement of the price stability target at the earliest possible time.

The Bank made a clear commitment to achieve the 2 percent price stability target at the earliest possible time, with a time horizon of about two years. As a means of underpinning the commitment, the Bank has embarked on a new monetary easing policy, that is, quantitative and qualitative monetary easing. We believe that the Bank's strong commitment and decisive actions will significantly change the expectations among firms and households. Looking at the financial markets, market expectations appear to have started changing. Looking also at indicators that show the expected rate of inflation of the market and economic entities, some have suggested an increase. Positive moves have started to take place, driven by the Bank's quantitative and qualitative monetary easing. In further pursuing the policy, we expect such moves to spread to firms and households, and deflationary expectations to be reversed. Those firms and households released from deflationary expectations are expected to make active investment and consumption by fully utilizing accommodative financial conditions. Such positive economic activity and a change in expectations will induce an improvement in the real economy and a rise in the expected rate of inflation, paving the way to the achievement of the 2 percent price stability target.

Final remarks

The government has set its economic policy with a combination of three-pronged strategy (three arrows). Namely, bold monetary easing, flexible fiscal policy, and a growth strategy to promote private investment. As for the first arrow of bold monetary easing, the Bank, aiming to achieve the price stability target, has introduced a new monetary easing policy of quantitative and qualitative monetary easing. Naturally, in meeting our price stability target, we do not want to see only consumer prices climbing to 2 percent. The price stability target we aim at should be achieved in a virtuous cycle in which the real economy improves in a balanced manner, accompanied by an increase in corporate profits, employment, and wages. If the government can effectively deliver two other arrows and create real demand, that would underpin the virtuous cycle. It would enable the Bank to achieve the price stability target more smoothly. The government has already started various initiatives, and I have high hopes for more to follow.

At the same time, to continue with quantitative and qualitative monetary easing, it needs to be recognized by the public that the Bank's purchase of JGBs is carried out solely to achieve the price stability target and not in any way to finance the fiscal deficit. To that end, it is critical to maintain fiscal credibility. The government and the Bank released a joint statement in January. The government clearly stated that it would 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.

The Bank of Japan Act stipulates that the principle of monetary policy conduct should "be aimed at achieving price stability, thereby contributing to the sound development of the national economy." Overcoming the longstanding challenge of deflation and achieving sustainable growth with price stability conform with the principle. Japan's economy has started picking up, and now is a great opportunity to overcome the challenge. I believe seizing the opportunity is our manifest mission.

Thank you.