Haruhiko Kuroda: Overcoming deflation with quantitative and qualitative monetary easing

Remarks by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at the International Financial Symposium, hosted by the Institute for International Monetary Affairs, Tokyo, 19 March 2014.

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Introduction

It is my honor to be an invited panelist at the International Financial Symposium hosted by the Institute for International Monetary Affairs.

The theme of the symposium is the important issue of challenges and policies for world economic growth. Looking at the current situation of the global economy, it has finally overcome the financial crisis following the Lehman shock and has recently been heading toward recovery on the whole. However, the pace of recovery remains moderate and a risk of the euro area and other advanced economies tumbling into deflation has been noted. I do not think that such risk is significant because medium- to long-term inflation expectations are anchored at the levels central banks are aiming at. *Inflation expectations* is the key term in Japan's experience of deflation and challenge toward overcoming deflation, which I am going to talk about now.

Long fight against deflation

In retrospect, a series of events since the second half of the 1990s – such as banks' nonperforming loan problems, the Asian currency crisis, the Lehman shock, and the Great East Japan Earthquake – weighed strongly on Japan's economy. In addition, a variety of factors put direct downward pressure on prices, such as low-priced imports from emerging economies and firms' low-price strategies to counter intensifying competition stemming from deregulation. In response, the Bank of Japan implemented a series of unconventional monetary policies ahead of other central banks around the globe, such as the zero interest rate policy, the quantitative easing policy, and forward guidance. With these policies serving to stimulate economic activity, the economy headed toward recovery from time to time. However, these policies failed to put an end to the trend of a price decline. Rather, people's inflation expectations declined as deflation became protracted, and deflationary expectations – a sense that prices would not increase – became entrenched.

In a world in which deflationary expectations are entrenched, the holding of cash or deposits becomes a relatively better investment strategy, and firms' incentives to launch new initiatives through investing in business facilities and in research and development become reduced. Thus, Japan's economy was deprived of vitality and this generated a vicious cycle in which the low vitality made it more difficult to overcome deflation. Due to its long persistence, deflation has become a challenge that is more and more difficult to overcome.

In order to escape from such a situation, it has become necessary to pursue a policy that quickly and drastically changes people's sense that prices will not increase. To that end, what was introduced as a prescription last April was quantitative and qualitative monetary easing (QQE). This policy differs from the Bank's past monetary easing policies, as well as monetary easing policies implemented by major central banks overseas, in that its policy effects focus on dispelling deflationary expectations by directly working on people's expectations; in other words, on raising people's inflation expectations.

The QQE

The QQE comprises two elements. First, to eliminate deflationary expectations that were entrenched among firms and households, the Bank showed its determination that it would definitively overcome deflation through a strong and clear commitment. The Bank clearly stated that it would "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," and thus clearly specified the period in which it would achieve the target. Second, given that deflation had continued for a long period, even with a strong commitment, it was difficult for the Bank's strong determination to be viewed as convincing without any underpinning measures in place. The Bank therefore decided to double the monetary base in two years, and to achieve this it decided to massively purchase Japanese government bonds (JGBs), including those with longer remaining maturities. So far, the Bank has been pursuing the decided provision of the monetary base, and the year-on-year rate of increase in the monetary base was about 55 percent in February. The monetary base is expected to reach about 56 percent of nominal GDP at the end of this year. This far exceeds the current ratio of 22 percent of the Federal Reserve in the United States and 22 percent of the Bank of England in the United Kingdom, and is an unprecedented monetary easing.

The key to the QQE's transmission mechanism is the lowering of real interest rates. By raising inflation expectations through a clear commitment and underpinning large-scale monetary easing on the one hand and containing nominal interest rates through massive purchases of JGBs on the other, real interest rates will be lowered, thereby generating the effect of powerfully stimulating economic activity. As the real economy improves due to such stimulus, the actual inflation rate will rise, which will lead to a further rise in inflation expectations: such a virtuous cycle can be expected to operate.

Is such a mechanism actually at work? So far, the QQE has been steadily exerting its intended effects. Surveys on various economic entities and break-even inflation rates have suggested a rise in inflation expectations on the whole. As for nominal interest rates, in contrast with other advanced economies in which long-term interest rates have been rising in tandem with economic recovery, Japan's long-term interest rates have been hovering in a stable manner at an extremely low level of around 0.6 percent.

Under such financial conditions, Japan's economy has continued to recover moderately in association with a virtuous cycle among production, income, and spending. On the price front, the year-on-year rate of change in the CPI excluding fresh food was negative when the QQE was introduced but has since improved, registering a positive figure of around 1¼ percent in the latest data. One year has passed since the introduction of the QQE, and we have reached the midpoint of "about two years" that we specified. So far, Japan's economy has been following the path toward achieving the 2 percent price stability target as expected, and we have become increasingly confident that the anticipated transmission mechanism of the QQE is actually working.

In Japan, two rounds of consumption tax hikes are scheduled. Based on the experience of the economy going into recession when consumption tax was raised last time, in 1997, there are some concerns that the same might happen again. However, looking at the economic conditions of that time, the economic growth rate plunged immediately after the tax hike but subsequently showed signs of recovery. The economy seemed to have instead been affected substantially by a series of failures of Japanese major financial institutions and by the Asian currency crisis that took place just when the economy showed nascent recovery. By contrast, at present, Japan's financial system has been maintaining stability and emerging economies have become more resilient against negative shocks. The current conditions are quite different from those in 1997. Taking these differences into account, the Bank believes that, even assuming two consumption tax hikes, the virtuous cycle in the economy will not be interrupted and Japan's economy will continue to grow above its potential growth rate as a trend.

Challenges ahead to achieve the 2 percent

To conclude, let me briefly touch on one of the challenges that lies ahead; namely, how prices and wages will be set when we achieve 2 percent inflation in a stable manner. The Bank is committed to continue with the QQE as long as it is necessary for maintaining the 2 percent price stability target in a stable manner. We are aiming at an economy and society in which actual inflation rates will be around 2 percent on average, and in which firms and households will behave on the assumption that prices will increase by about 2 percent. In the United States and Europe, people's medium- to long-term inflation expectations have been anchored at about 2 percent, and the setting of prices and wages based on these expectations has been firmly established. We would like to achieve this in Japan as well. On this point, there have been encouraging developments in annual wage revisions for next fiscal year. We are paying close attention to how the wage decision framework based on the assumption of price rises will be created.

Concluding remarks

The QQE, which I have talked about today, holds the huge challenge of raising inflation expectations through monetary policy. So far, with the policy exerting its intended effects, Japan's economy has been stepping toward achieving the 2 percent price stability target as expected. Of course, we are only halfway there. The Bank will steadily pursue the QQE to overcome as soon as possible the deflation that has continued for nearly 15 years. It will examine both upside and downside risks to economic activity and prices, and make adjustments if necessary to achieve the price stability target.

Thank you.