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The Battle Against Deflation:

The Evolution of Monetary Policy and Japan's Experience

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The Italian Academy, Columbia University

Haruhiko Kuroda

Governor, Bank of Japan

On April 13, 2016, the Center on Japanese Economy and Business (CJEB) at Columbia Business School (CBS) hosted a special lecture featuring remarks by Haruhiko Kuroda, Governor of the Bank of Japan (BOJ), titled “The Battle Against Deflation: The Evolution of Monetary Policy and Japan’s Experience.” The lecture was moderated by Takatoshi Ito, professor at Columbia University’s School of International and Public Affairs and associate director of research at CJEB. Hugh Patrick, director of CJEB and R. D. Calkins Professor of International Business Emeritus at CBS, provided introductory remarks, and David E. Weinstein, Carl S. Shoup Professor of the Japanese Economy at Columbia University and director of research at CJEB, concluded the program.

Governor Kuroda began his remarks by stating that Japan has had a deflation problem for many years; this problem was even thought to be unique to Japan. During the late 1990s and 2000s, up until the financial crisis of 2008, other economies were performing well – the United States had overcome several shocks, European economic integration led to stable growth with a common currency, and emerging economies were rapidly growing. Although many economic interventions saved the global economy from a second Great Depression in 2008-09, the global economy, including advanced economies, continues to face low growth and inflation, elevating concerns that these economies may be destined for Japanese-style deflation.

Hugh Patrick

Governor Kuroda proclaimed that the end of Japan's deflationary problem is now on the horizon as a result of quantitative and qualitative monetary easing (QQE), introduced three years ago. He reviewed the ways in which Japan has combated deflation, from the theoretical foundations to an "unconventional" monetary policy.

Governor Kuroda defines deflation as a situation in which prices of a broad basket of goods and services declines in a consistent manner, thereby causing all consumer prices to continually fall. When looking at the overall economy, deflation causes a decrease in sales, and therefore profits, which spurs employee layoffs and/or wage decreases. Consumers then hold back on spending as the future looms with uncertainty. Subsequently, competition between firms becomes fiercer, causing price races to the bottom. Deflation is thus self-perpetuating: the economy falls into a "bad equilibrium, in which economic activity is shrinking." This has been the state of Japan's economy for 15 years, first triggered by the burst asset bubble and the destabilization of the financial system during the late 1980s and early 1990s. This prolonged deflation, in turn, has firmly influenced consumer sentiment that prices and wages will not rise again.

Takatoshi Ito

Haruhiko Kuroda

Deflation causes the real value of the currency to increase as the situation persists: however, the nominal value is unchanged and interest rates remain positive. Consumers assume prices will continue to decline so they find it preferable to hold on to their cash and buy goods and services at a later time. Businesses hold off on investments and instead mitigate risk by cutting costs, including wages, and holding bank deposits. Typically, the corporate sector is a net borrower, but, as a result of deflation, in Japan during the late 1990s the sector turned into a net saver. The government first intervened by issuing bonds and increasing fiscal spending. Bank deposits increased while lending decreased; banks used their cash on hand to invest in government debt. In this environment, Japan's corporate sector had a financial surplus, the government was in deficit, and the banks were highly invested in government bonds.

Another result of persistent deflation is that real interest rates remain high. The real interest rate – the nominal interest rate adjusted for inflation – is the relevant figure when assessing economic activity. When inflation expectations turn negative, the real interest rate will remain high compared to the nominal rate, reducing productivity and innovation while also hindering the effectiveness of monetary policy.

Haruhiko Kuroda

The BOJ is often criticized for policies considered "too little, too late," though it did adopt many unconventional measures as early as the late 1990s. In 1999, the BOJ adopted a "zero interest rate policy," where the overnight money market rate was guided close to zero. Then, in 2001, the BOJ enacted the world's first quantitative easing: it targeted current account balances held by financial institutions by providing liquidity, allowing reserve balances to rise. At the same time, the BOJ issued what is now called "forward guidance" by openly committing to keep the policy until consumer prices' annual rate of change was a stable zero percent or had increased.

However, as a result of the 2008 financial crisis, Japan's economy was weakened along with the rest of the global economy, causing positive inflation to turn negative. Subsequently, the BOJ adopted a policy of "comprehensive monetary easing" in which it purchased short-maturity Japanese government bonds, thus pushing down bond interest rates to close to zero. This was done in parallel with buying up private-sector debt (corporate bonds, commercial paper, exchange-traded funds, real estate investment trusts, etc). Further, the BOJ introduced low interest rate long-term lending facilities to encourage lending by financial institutions. These unconventional measures prevented a severe deflationary spiral, but none were able to overcome the persistent deflation characteristic of the Japanese economy.

The main channel through which monetary easing seeks to spur economic growth is via the natural rate of interest: the real interest rate where the economy neither accelerates nor decelerates. The aim of monetary easing is to push real interest rates below the natural rate by lowering the policy rate and increasing liquidity to stimulate economic activity. Many economists agree that the potential growth rate of an economy is a major determinant of the natural rate of interest.

Haruhiko Kuroda

Japan was thus faced with two challenges regarding its deflationary situation: first, high real interest rates persisted even though nominal short-term interest rates were already near zero. Further, low inflation expectations also persisted, reinforcing the high real interest rates. Second, the natural rate of interest had declined, coinciding with a decline in growth potential, which was compounded by Japan's aging population. With Japan's growth potential reduced, capital accumulation was also slow. As a result, Japan was forced into a corner where it was faced with the zero lower bound on nominal interest rates and a decline in inflation expectations – so the real interest rate remained high.

The deflationary trap resulted in many challenges for Japan's policy authorities. They needed to raise the potential growth rate and thereby increase the natural rate of interest while simultaneously creating monetary policy to lower real interest rates. Facing these challenges, in 2012, the Abe Administration launched "Abenomics," which consisted of "three arrows:" 1) bold monetary policy, 2) flexible fiscal policy, and 3) a growth strategy to promote private investment.

Haruhiko Kuroda, Takatoshi Ito

The BOJ introduced a price stability target of 2 percent CPI inflation just before Governor Kuroda was appointed as governor of the BOJ in March 2013, and following the Federal Reserve's announcement of a similar inflation goal. In April 2013, the BOJ introduced QQE which consists of two elements: first, to raise inflation expectations via the BOJ's commitment to achieving the price stability target and second, through large government bond purchases by the BOJ, exerting downward pressure on short-term nominal interest rates and on the entire yield curve. This combination allows the BOJ to also influence long-term real interest rates. Since its introduction, the pace of QQE bond buying has accelerated from an annual pace of 50 trillion yen to 80 in October 2014. These bond purchases correspond to about 16 percent of Japan's nominal GDP, thus increasing the ratio of the BOJ balance sheet from 35 to 77 percent as of December 2015.

Haruhiko Kuroda, Takatoshi Ito

Japan has seen the intended results of QQE. Nominal long-term interest rates have declined. A widely watched survey of economists indicates that medium- to long-term inflation expectations have correspondingly risen. As such, real long-term interest rates have declined as well. The BOJ asserts that the effects of QQE on the entire yield curve are equivalent to a lowering of the short-term policy rate by 2 percent. Further, lending has increased at a moderate pace. This

David E. Weinstein

decline in the real interest rate can be seen by an increase in corporate profits, and there has also been a rise in business fixed investment. The unemployment rate has declined to about 3 percent, which can be regarded as full employment. An increase in workers' base pay occurred for the first time in around 20 years. As a result, private consumption has been resilient. This moderate recovery has led to a steady increase in inflation. Though Japan has not yet reached its 2 percent target, Governor Kuroda indicated that it is clear that there has been significant positive change in inflation trends as a result of QQE.

To continue the recovery in the wake of unstable global financial markets, further oil price declines, and shaky emerging market economies (namely China), the BOJ decided to introduce "QQE with a Negative Interest Rate" this January. The BOJ predicted that this market volatility could have an effect on inflation expectations given that the deflationary spiral is still fresh in the minds of Japanese consumers and businesses. With this policy, the BOJ aims to lower the short end of the yield curve by applying a negative interest rate of minus 0.1 percent on a part of financial institutions' current account balances at the BOJ. In combination with large-scale bond purchases, the BOJ is putting downward pressure on interest rates, resulting in a decline in the real interest rate. This policy enhances the effects of existing measures by pushing down the short-end of the yield curve.

David E. Weinstein

A challenge to this policy is that a negative interest rate can cause banking sector profitability to decline as private banks hold on to assets given the negative yield; the yield spreads are a financial institution's main source of earnings. A reduction in bank profitability could undermine the stability of the financial sector, which would weaken the results of monetary easing. However, Governor Kuroda asserted, there is no way that this would occur in the context of Japan. Japan's financial institutions have a sufficient capital buffer, since they did not suffer much during the financial crisis. Further, credit costs have declined since bankruptcies have declined, and banks have experienced record-level profits. The BOJ was able to avoid a hit on bank profitability by adopting a three-tier system in which current accounts are divided into three different interest rate tiers, and only one is subject to the negative interest rate.

The impact of the negative interest rate policy is already clearly visible in developments in Japanese government bond yields. Interest rates across the entire yield curve have declined while benchmark rates for business lending and mortgages have also declined. Governor Kuroda stated that he expects that the effects of this policy will continue to spread to the real economy and to inflation. As such, this “enhanced QQE” will continue until the price stability target of 2 percent is achieved: this is the most powerful monetary easing in modern central banking history. Governor Kuroda closed his remarks by stating that Japan's experience of fighting persistent deflation can be used as a case study by other central banks so that they can fulfill their mission of ensuring price stability in this ever-changing and challenging global economy.

Following Governor Kuroda’s remarks, Professor Ito moderated a question and answer session with the audience. Professor Weinstein concluded the session.

David E. Weinstein, Haruhiko Kuroda, Hugh Patrick, Takatoshi Ito